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No. A-1115
IN THE

Supreme Court of the United States

October Term, 1981

HILTON HOTELS CORPORATION, successor to FLAMINGO RESORT, INC.,

Petitioner,

vs.

UNITED STATES OF AMERICA,

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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Questions Presented for Review.

1. Should this Court review the decision of the Ninth Circuit Court of Appeals, which, contrary to prior decisions of this Court and the Tax Court and the long-standing position of the Internal Revenue Service, holds that a taxpayer must accrue income and pay taxes upon mere promises to pay, even though the taxpayer does not have a legally enforceable right to collect upon such promises under any circumstances?

2. Should this Court review the decision of the Ninth Circuit Court of Appeals, which departs from the clear, certain, and administratively workable "all-events" test articulated by this Court over one-half century ago (and applied since then by this Court, the lower federal courts, and the Internal Revenue Service) to determine when income is realized by accrual basis taxpayers?

3. Should this Court review the decision of the Ninth Circuit Court of Appeals, which creates serious uncertainty for both taxpayers and the Internal Revenue Service in the timing of deductions of business expenses for accrual basis taxpayers, and which, if applied as written, may result in hundreds of millions, if not billions, of dollars in business expense deductions being accelerated to the substantial detriment of the United States Treasury?

Parties in the Court of Appeals.

Petitioner, Hilton Hotels Corporation, is the successor in interest to Flamingo Resort, Inc., the plaintiff-appellant in an action brought in the United States District Court for the District of Nevada and subsequently appealed to the United States Court of Appeals for the Ninth Circuit. The United States of America is the defendant-appellee in the District Court and in the Ninth Circuit Court of Appeals.

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ERRATA

HILTON HOTELS CORPORATION (Parent Company)

	% Hilton Ownership
Hilton Service Corporation	51
Statler Dallas Corporation	49
Main and Holcombe Corporation	40
Hilton Reservation Equipment Company	51
Beverly Hilton Joint Venture	50
Dallas Hilton Joint Venture	50
Commerce Garage Joint Venture	50
Compass Computer Services, Inc.	50
D. C. Statler Hilton Joint Venture	50
Hilton Burns Kona Partnership	50
Hilton Hawaiian Village Joint Venture	50
Los Angeles Hilton Joint Venture	50
New York Hilton Joint Venture	50
Adjacent Properties Co-Ownership	50
Rye Hilton Joint Venture	50
San Francisco Hilton Joint Venture	50
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OPINIONS BELOW.

The opinion of the United States Court of Appeals for the Ninth Circuit is reported at 664 F.2d 1387 (9th Cir. 1982), and is set out at page 1 of the Appendix (hereinafter cited as "App. ....").

The opinion of the United States District Court for the District of Nevada is reported at 485 F. Supp. 926 (D. Nev. 1980), and is set out at App. 10.

GROUNDS FOR INVOKING THIS COURT'S JURISDICTION.

The decision of the United States Court of Appeals was issued January 7, 1982. Plaintiff-appellant timely filed a Petition for Rehearing En Banc, which was denied by the United States Court of Appeals in an order entered April 2, 1982. A copy of the order is set out at App. 38. On June

23, 1982, Justice Rehnquist signed an order allowing Hilton until July 26, 1982 to file this petition.

The jurisdiction of the Court is invoked under 28 U.S.C. § 1254(1).

CONSTITUTIONAL PROVISIONS, STATUTES, AND REGULATIONS INVOLVED.

Section 446 of the Internal Revenue Code, 26 U.S.C. § 446, provides, in relevant part:

> (a) General rule. — Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.
>
> (b) Exceptions. — If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.
>
> (c) Permissible methods. — Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting —
>
> (1) the cash receipts and disbursements method;
>
> (2) an accrual method;
>
> (3) any other method permitted by this chapter; or
>
> (4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

Section 451 of the Internal Revenue Code, 26 U.S.C. § 451, provides, in relevant part:

> (a) General rule. — The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing

taxable income, such amount is to be properly accounted for as of a different period.

Treasury Regulation § 1.446-1(c)(1)(ii) provides, in relevant part:

> (ii) Accrual method. Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations.

Treasury Regulation § 1.451-1(a) provides, in relevant part:

> (a) General rule. Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

STATEMENT OF THE CASE.

The Internal Revenue Service asserted a deficiency in the income tax payments of Flamingo Resort, Inc., for the period from August 17, 1967, the date of its incorporation, to December 31, 1967. Hilton later acquired Flamingo and

succeeded to its rights and liabilities for the period in question, as well as subsequent years. On December 22, 1975, Hilton, on behalf of Flamingo, paid the asserted deficiency together with interest, which amounts to $265,034.34, and filed a claim for a refund in the same amount. Following the denial of this claim by the Internal Revenue Service, this action in the name of Flamingo was commenced in the District Court to recover the overpayment, pursuant to 28 U.S.C. § 1346(a)(1).

Flamingo was the legal, licensed owner and operator of a gaming resort in Las Vegas, Nevada, known as the Flamingo Hotel and Casino. During the time in question, Flamingo operated games of chance as a regular and substantial part of its legitimate business activity. Many patrons gambled with chips obtained in return for either cash or a "marker" in the amount of the chips transferred to the patron. A "marker" is, in form, a promise to pay. Because markers issued for gambling purposes are legally unenforceable, these instruments simply "mark" the amount of gaming credit extended to a patron.

Exchanges of cash or markers for chips occurred either in the "pit" area, where the games of chance were conducted, or at the "cage," an enclosed portion of the gaming area with cashiers' windows resembling tellers' windows in a bank. This distinction gives rise to markers being termed "pit markers" or "cage markers," depending upon where such exchanges occurred.

Markers, the consideration for which is used in gambling, as well as any instrument given in payment of a gambling debt, are and always have been absolutely void and unenforceable under Nevada law, even in the hands of a holder in due course. *Sandler v. District Court*, 96 Nev. 622, 614 P.2d 10 (1980); *Sea Air Support, Inc. v. Herrmann*, 96 Nev. 574, 613 P.2d 413 (1980); *Corbin v. O'Keefe*, 87

Nev. 189, 484 P.2d 565 (1971); *Wolpert v. Knight*, 74 Nev. 322, 330 P.2d 1023 (1958); *Weisbrod v. Fremont Hotel*, 74 Nev. 227, 326 P.2d 1104 (1958); *West Indies v. First Nat. Bank*, 67 Nev. 13, 214 P.2d 144 (1950); *Burke v. Buck*, 31 Nev. 74, 99 P. 1078 (1909); *Evans v. Cook*, 11 Nev. 69 (1876); *Scott v. Courtney*, 7 Nev. 419 (1872). Consequently, Flamingo could not enforce collection of such markers anywhere. *Intercontinental Hotels Corp. (Puerto Rico) v. Golden*, 254 N.Y.S.2d 527 (N.Y. 1964); *Dunes Hotel & Country Club of Las Vegas v. Mayo*, 354 N.Y.S.2d 62 (N.Y. City Ct. 1974); *Hamilton v. Abadjian*, 179 P.2d 804 (Cal. 1947).

Flamingo reported taxable income on the accrual method of accounting. In computing its income tax liability for 1967, Flamingo did not treat its unpaid markers as assets or revenue for tax purposes. The Internal Revenue Service did, and increased Flamingo's income for the year by including as "casino receivables" unpaid markers in the amount of $676,432 on hand on December 31, 1967, less $130,721 which was treated as an addition to Flamingo's reserve for bad debts. Flamingo instituted the District Court action to recover the additional tax it was compelled to pay for the tax period in question as a result of this assessment.

During the District Court proceedings, Flamingo moved for partial summary judgment with respect to its liability for taxes on "pit markers."[1] The Government responded

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[1]The Nevada Supreme Court has developed certain presumptions with respect to instruments regular in form but asserted to have been executed in furtherance of a gambling transaction. *See Craig v. Harrah*, 66 Nev. 1, 6, 201 P.2d 1081, 1084 (1949). Consequently, an instrument cashed at a casino cage may be enforceable, if its maker fails to establish that the proceeds therefrom were used for gambling. On the other hand, if an instrument is exchanged for chips at or near a game of chance, during the progress of play, by one engaged in gambling, a gambling purpose is imputed, and the instrument is unenforceable. *Wolpert v. Knight, supra; Craig v. Harrah, supra; Burke v. Buck, supra.*

by moving for summary judgment on all markers, contending that legal enforceability was irrelevant because the exchange of a marker for chips was, in essence, a loan from Flamingo to its patron; that this "loan" and its subsequent collection, if collection occurred, were non-taxable events; that when Flamingo won back chips (which the patron had "borrowed") income was realized; and that the amount of such "income" was measured by the amount of the marker.[2]

While these motions were under submission in the District Court, the Government and an unrelated taxpayer were litigating the *identical* legal issue on substantially identical operative facts in the United States Tax Court. *Desert Palace, Inc. v. Commissioner*, 72 T.C. 1033 (1979). In *Desert Palace*, in which the Tax Court held for the taxpayer, the Government unequivocally acknowledged that Flamingo was correct in asserting that legal enforceability of a promise to pay was essential to accrual of the promise as income. In written response to questions posed by the Tax Court, the Government stated:

> Legal enforceability of casino receivables is a necessary ingredient in determining when the petitioner's right to receive gambling income is fixed within the meaning of Treas. Reg. § 1.446-1(c)(1)(ii). Under an accrual method of accounting, income accrues only when all the events have occurred which fix the taxpayer's right to receive such income. *United States v. Anderson*, 269 U.S. 422 (1926); *Spring City Co. v. Commissioner*, 292 U.S. 182 (1934). *The unenforceability of the gambling debts receivables affects the accrual of income in that it presents a contingency which precludes accrual of income under the all events*

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[2]The District Court eventually rejected this argument of the Government. *Flamingo Resort, Inc. v. United States*, 485 F. Supp. 926, 937 (D. Nev. 1980).

> *test of Treas. Reg. § 1.446-1(c)(1)(ii).* [Emphasis added.]

Tax Court's Order, dated December 8, 1978, and Supplemental Brief for Respondent (the Government) in the *Desert Palace* case, set out in full in the Appendix to this petition, beginning at page 39 and page 40, respectively.

Thereafter, in this action in the District Court, the Government reiterated this interpretation of the Treasury Regulations involved:

> The *Desert Palace* case deals with issues identical to those in the instant case. It is true that the Government there argued that, due to the legal unenforceability of pit markers, the taxpayer casino need not accrue income upon the *receipt* of such markers. It is likewise true that the Government there stipulated that outstanding chips do not represent *legal* obligations of the casino. The latter point is a matter of Nevada law, and we do not deviate in the slightest from those positions in this case.

Reply Memorandum of Points and Authorities in Support of the Government's Cross-Motion for Summary Judgment, set out in full in the Appendix beginning at page 43, at page 47 (emphasis by the Government).

Notwithstanding this construction of its own Treasury Regulation by the Government in two independent cases, the District Court held that "the income represented by casino receivables is accruable under the 'all events' test" because "legal enforceability is not a necessary element of a fixed right to receive income." *Flamingo Resort, Inc. v. United States*, 485 F. Supp. 926, 939 (D. Nev. 1980). On this basis the District Court granted summary judgment to the Government.

Flamingo appealed. The Ninth Circuit Court of Appeals affirmed, agreeing with the District Court that because

Flamingo had a "reasonable expectancy of collection" of many of its markers, "accrual was proper despite the absence of legal enforceability." *Flamingo Resort, Inc. v. United States*, 664 F.2d 1387, 1388, 1390 (9th Cir. 1982).

Hilton Hotels Corporation, as successor in interest to Flamingo, now petitions this Court to review this conclusion by a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

REASONS FOR ALLOWANCE OF THE WRIT.

I.

THE NINTH CIRCUIT HAS ABANDONED LEGAL ENFORCEABILITY AS AN ESSENTIAL ELEMENT FOR THE ACCRUAL OF INCOME, THEREBY CREATING A CONFLICT WITH PRIOR DECISIONS OF THIS COURT, OTHER COURTS OF APPEAL, THE TAX COURT, AND WITH THE LONG-STANDING POSITION OF THE INTERNAL REVENUE SERVICE ON THE MEANING AND APPLICATION OF THE ALL-EVENTS TEST.

The conflict just described is real, as demonstrated in the following paragraphs.

A. Decisions of This Court.

More than fifty years ago, this Court enunciated the test which governs accrual accounting for income tax purposes to this day. In *United States v. Anderson*, 269 U.S. 422, 46 S.Ct. 131, 70 L.Ed. 347 (1926), the question presented was the deductibility of a tax, which had not been assessed, and thus was not yet due and payable. Holding that a deduction was nevertheless proper, this Court observed that

> In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all of the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it.

269 U.S. at 441.

Four years later the Court applied this "all-events" test to the corresponding question of the accrual of income for income tax purposes. In *Lucas v. North Texas Lumber Co.*, 281 U.S. 11, 50 S.Ct. 184, 74 L.Ed. 668 (1930), an executory contract for the sale and purchase of certain real property was entered into prior to the end of the tax year. Closing of the transaction, including payment of the pur-

chase price, was contingent only on the exchange of the necessary papers, but this did not occur until the next year. As a result, this Court refused to permit the taxpayer (the vendor) to accrue the income represented by the purchase price of the property because "The title and right of possession remained in [the vendor] until the transaction was closed. Consequently, unconditional liability of vendee for the purchase price was not created in that year." 281 U.S. at 13.

At all times since these two decisions, unconditional liability of the debtor has been an unwavering requirement for the accrual of income and deductions for tax purposes. Thus in *North American Oil Consolidated v. Burnet*, 286 U.S. 417, 52 S.Ct. 613, 76 L.Ed. 1197 (1932), this Court rejected the Government's contention that income should be accrued prior to the entry of a court decree vacating a receivership. In the Court's view, the decree would be necessary to establish the "*right* in the [taxpayer] company to demand" payment of profits paid to the receiver (the income in dispute). 286 U.S. at 423 (emphasis added).

Two years later, in *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 54 S.Ct. 644, 78 L.Ed. 1200 (1934), this Court required the accrual of an account receivable in full, even though a petition in bankruptcy had been filed against the account debtor, saying: "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues." 292 U.S. at 184-185 (emphasis in original).

Consistent with *Spring City Foundry* this Court in *United States v. Safety Car Heating & Lighting Co.*, 297 U.S. 88, 56 S.Ct. 353, 80 L.Ed. 500 (1936), precluded an accrual

basis taxpayer from including income received as a result of patent infringement litigation as taxable income for the year in which its claim arose, reasoning that "the existence of any liability was contested and uncertain" until the infringement issue was decided and "[t]he amount remained contested and uncertain" until several years later, "when there was a settlement of the liability. . . . Then for the first time the profits flowing from the infringement became taxable as income." 297 U.S. at 93-94

And in the same vein in *Estate of Putnam v. Commissioner*, 324 U.S. 393, 65 S.Ct. 811, 89 L.Ed. 1023 (1945), this Court refused to require accrual (to a deceased taxpayer) of a corporate dividend on the date of its declaration because the dividend was payable and paid to stockholders of record on a later date. Noting that the identity of the recipient was thus not determined as of the date of declaration, this Court observed: "Such uncertainty destroys any conception of accrual as involving a *right* to receive or an obligation to pay, elements which we think are essential for accruals under our decisions." 324 U.S. at 400 (emphasis added).

That the Court's repeated reference to "right to receive" in accrual cases means "legally enforceable right" is unequivocally established by this Court's recent decision in *United States v. Byrum*, 408 U.S. 125, 92 S.Ct. 2382, 33 L.Ed.2d 238 (1972). In *Byrum* this Court considered the meaning of "right . . . to designate" in Section 2036 of the Internal Revenue Code, 26 U.S.C. § 2036(a), and concluded:

> The term 'right,' certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and *legally enforceable power*. . . . Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to 'regulate the flow of divi-

> dends' to the trust. *That 'right' was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term.*

408 U.S. at 136-137 (emphasis added).

In short, the Ninth Circuit's decision here is in conflict with prior decisions of this Court regarding a core concept of the income tax laws.

B. Long-standing Interpretation by the IRS.

The principles set out in this Court's opinions, which are summarized above, are embodied in Treasury Regulation § 1.446-1(c)(1)(ii), which states, in pertinent part:

> *Accrual method.* Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy.

In the District Court in *this* case the Government reaffirmed without qualification the interpretation of Treasury Regulation § 1.446-1(c)(1)(ii), which it formally articulated in writing in the *Desert Palace* case.

> Legal enforceability of casino receivables is a necessary ingredient in determining when the petitioner's right to receive gambling income is fixed within the meaning of Treas. Reg. § 1.446-1(c)(1)(ii). Under an accrual method of accounting, income accrues only when all the events have occurred which fix the taxpayer's right to receive such income. *United States v. Anderson*, 269 U.S. 422 (1926); *Spring City Co. v. Commissioner*, 292 U.S. 182 (1934). The unenforce-

> ability of the gambling debts receivables affects the accrual of income in that it presents a contingency which precludes accrual of income under the all events test of Treas. Reg. § 1.446-1(c)(1)(ii).

Supplemental Brief for Respondent in the *Desert Palace* case, App. 41-42; *see* the Reply Memorandum of Points and Authorities in Support of the Government's Cross-Motion for Summary Judgment, in the District Court, App. 47.

The Government's position in the District Court in this action and in the Tax Court in *Desert Palace* is a continuation of and completely consistent with the position of the Internal Revenue Service for the last sixty years. In 1921 the Bureau of Internal Revenue issued a public pronouncement that a taxpayer who made usurious loans could not report the interest income from the loan prior to the year in which it was actually received because "the unpaid notes held by him are not legal obligations of the makers and are not collectible under due process of law." Office Decision 1139, 5 C.B. 84 (July-December 1921). This Office Decision has *never* been said to be incorrect; it was not declared obsolete until December 1974 (see Rev. Rul. 74-621, 1974-2 C.B. 405, first published in 1974-52 I.R.B. 14), despite the *directly* contrary decisions, on identical facts, in *Barker v. Magruder*, 95 F.2d 122 (D.C. Cir. 1938) and *Barker v. United States*, 26 F. Supp. 1004 (Ct. Cl. 1939), relied upon by the Ninth Circuit and the District Court in this case.[3]

Nor had the Service's position changed by 1974, which was seven years *after* the tax period involved here. In 1965

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[3]The fact the Office Decision was declared obsolete is not, however, an indication that the Commissioner believed it was incorrect. In accordance with Rev. Proc. 67-6, 1967-1 C.B. 576, a large number of older rulings were declared obsolete between 1967 and 1974, because, among other things, issues are now covered by regulations and statutes or regulations have changed, or the ruling has no precedential value because the fact situation no longer exists.

the Commissioner acquiesced in the key portion of the Tax Court's decision in *The Marquardt Corporation v. Commissioner*, 39 T.C. 443 (1962), *acq.* 1965-2 C.B. 6, *non-acq. as to another issue*, 1965-2 C.B. 7. In *Marquardt Corporation* the Tax Court refused to require a taxpayer customarily reimbursed by Boeing Aircraft Company for cost overruns to accrue the reimbursements when the overruns occurred because Boeing was not legally obligated to make such reimbursements under its contract with the taxpayer. The Tax Court declared:

> Under the accrual method of accounting, an item of income accrues when the taxpayer has a fixed unconditional right to receive it. It is the right to receive and not the actual receipt of an amount which determines its accruability. *Spring City Co. v. Commissioner*, 292 U.S. 182 (1934); *Estate of Putnam v. Commissioner*, 324 U.S. 393 (1945). Until the right to an amount becomes accruable through the fixing of the right to receive, the taxpayer is under no obligation to return it as income.
>
> We are concerned with the facts as they existed on December 31, 1953. [Citation omitted.] As of that date, petitioner had no fixed or unconditional right to receive any sum in excess of that authorized by Boeing. . . . There is little doubt that petitioner hoped and desired that it would get paid. However, this is not the test of accruability. The question is whether petitioner had a fixed or unconditional right. *Spring City Co. v. Commissioner, supra.*
>
> Respondent next contends that petitioner customarily overexpended and Boeing customarily overpaid the authorized amounts. Respondent contends that there was no substantial contingency barring petitioner's right to receive and Boeing's obligation to pay the amount in dispute.

> The facts do not support this contention. Even if petitioner had customarily overexpended, this unilateral action would not fix Boeing's obligation to pay, the thing necessary to require accrual. . . . Furthermore, respondent's argument overlooks the fact that the discretion to pay or not was in *Boeing*, not petitioner.

39 T.C. at 451-452 (emphasis in original).

In view of the Commissioner's acquiescence in this portion of *Marquardt Corporation*, the Government's interpretation of Treasury Regulation § 1.446-1(c)(1)(ii) presented in this case to the District Court, and to the Tax Court in *Desert Palace*, represents a position the Commissioner has maintained for over 60 years, since first asserting it in O.D. 1139, 5 C.B. 84 (July-December 1921), five years prior to this Court's decision in *United States v. Anderson, supra*. The Ninth Circuit's opinion is in irreconcilable conflict with this long-standing administrative interpretation and appears to ignore this Court's recent declaration on the weight to be accorded the Commissioner's interpretation of his own regulation.

In *Jewett v. Commissioner*, ... U.S. ..., 102 S.Ct. 1082, 1090 (1982), this Court reviewed in depth the history of Treasury Regulation § 25.2511-1(c), promulgated in 1958, and adopted the Commissioner's position saying:

> The Commissioner's interpretation of the regulation has been consistent over the years and is entitled to respect. This canon of construction, which generally applies to the Commissioner's interpretation of the Internal Revenue Code, *see* Commissioner v. Portland Cement Co. of Utah, 450 U.S. 156, 169, 67 L.Ed.2d 140, 101 S.Ct. 1037, is even more forceful when ap-

plied to the Commissioner's interpretation of his own regulation.

See also United States v. Leslie Salt Co., 350 U.S. 383, 396-397, 76 S.Ct. 416, 100 L.Ed. 441 (1956).

II.

THE NINTH CIRCUIT'S DECISION REQUIRES AN AD HOC, UNCERTAIN, AND ADMINISTRATIVELY UNWORKABLE APPROACH TO A CORE ISSUE OF THE INCOME TAX LAWS, WHICH IS SIGNIFICANT TO MILLIONS OF TAXPAYERS AND TO THE UNITED STATES TREASURY.

The Tax Court decisions in *Desert Palace* and *Marquardt Corporation*, discussed above, put that court in square conflict with the Ninth Circuit's decision in this case. Although the Ninth Circuit opinion arises out of an industry operating in only two states and on its face does not address the accrual of deductions from income, it would be a grave mistake to deem the opinion as being of little national significance, or as having minimal impact on private compliance with, and public administration of, the income tax laws. To the contrary, this is a case of profound significance in tax law and to the Government and all accrual basis taxpayers. Four real reasons support this conclusion.

First, it is common knowledge that a great number of taxpayers, including many of the Nation's major businesses, report income and expenses on the accrual basis. As a matter of fact, *every* business which maintains an inventory for sale *must* use the accrual method. Treasury Regulation § 1.446-1(c)(2)(i).

Second, legal enforceability as a prerequisite to the accrual of income is an issue of general concern. The issue is not limited to casino gaming or to the banking industry and its skirmishes with state usury laws. As demonstrated by the *Marquardt Corporation* case (manufacturing), the

issue may arise in any industry. The common, recurring fact pattern is simply this: Payor, in its discretion, regularly makes payments (without the legal obligation to do so) to an accrual basis taxpayer.

The ubiquity of this fact pattern leads to the third reason this case is of great national significance: The long-established approach to accrual of income — the approach mandated by this Court's opinions and the long-standing interpretation of the Internal Revenue Service — is founded on "legal enforceability." That term has meaning, shape, and substance to taxpayers in complying with the federal tax laws and to the Internal Revenue Service in administering them. Until the Ninth Circuit's opinion, both taxpayers and the Service had in the easily understood and applied standard of "legal enforceability" a tool that cut relatively cleanly between accrual and non-accrual and which made for fairness and certainty, primary goals of the tax laws. As pointed out in *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281, 285-286, 64 S.Ct. 596, 88 L.Ed. 725 (1944), the tax law must be neutral; exceptions should not be made "for the benefit of the Government or the taxpayer . . . because so to do would, in a given instance, work a supposedly more equitable result to the Government or to the taxpayer."

In stark contrast, the Ninth Circuit's approach is *ad hoc*, uncertain, and administratively unworkable. Under the Ninth Circuit's newly-fashioned approach, an expectation of payment can operate to elevate a taxpayer's legally unenforceable expectation to a "fixed right to receive": Flamingo collected up to 96 percent of its markers; hence it must accrue *all* markers. But what of 95 percent or 89 percent or 73 percent? How consistent must the payment history be? No more than 5 percent deviation from the mean? 10 percent? 50 percent? And how long a payment history?

Six months, twelve months, five years? These questions must be answered on a case-by-case basis under the Ninth Circuit's approach.[4]

The fourth reason for the belief that this case is significant offers, in our opinion, the strongest justification for this Court to review the Ninth Circuit's decision: The decision destroys the Government's ability to control and limit the timing and character of *deductions* from income for business expenses by accrual basis taxpayers. This could have a devastating effect on the Treasury. The reason for this result is simple and irrefutable: Accrual of income and accrual of deductions are simply two sides of the *same* coin; the same principles which govern the accrual of income also govern the accrual of expenses. Indeed, the venerable "all-events" test and the notion that legal liability is a central requirement for accrual accounting were first enunciated by this Court in the context of the deductibility of expenses. *United States v. Anderson, supra; see also, United States v. Consolidated Edison Co.*, 366 U.S. 380, 81 S.Ct. 1326, 6 L.Ed.2d 356 (1961); *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281, 64 S.Ct. 596, 88 L.Ed. 725 (1944); *Dixie Pine Products Co. v. Commissioner*, 320 U.S. 516, 64 S.Ct. 364, 88 L.Ed. 270 (1944). In sum, if mere expectations without legal enforceability require accrual of income (as the Ninth Circuit held), they will also permit accrual of deductions.[5]

That result of the Ninth Circuit's opinion reveals two glaring, significant flaws in the opinion. First, the decision

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[4]We are not creating a parade of horribles here; nor is this mere rhetoric. This is the reality of the Ninth Circuit's decision.

[5]This will be the conclusion of not only creative and imaginative tax analysts, advisers, and planners but of the most conservative and literal of that group. This effect of the Ninth Circuit's opinion cannot be ignored.

is flatly contrary to prior decisions of this Court and the long-standing public interpretation of them by the Internal Revenue Service, which permit deduction of only those expenses which meet the all-events test, and which reject the Ninth Circuit's "mere expectations" concept. In *Brown v. Helvering*, 291 U.S. 193, 54 S.Ct. 356, 78 L.Ed. 725 (1934), this Court rejected the deductibility of reserves for anticipated refunds of insurance premiums due to policy cancellations, saying that:

> The liability . . . arising from expected future cancellations was not deductible from gross income because it was not fixed and absolute. In respect to no particular policy written within the year could it be known that it would be cancelled in a future year. Nor could it be known that a definite percentage of all the policies will be cancelled in the future years. *Experience taught that there is a strong probability that many of the policies written during the taxable year will be so cancelled. But experience taught also that we are not dealing here with certainties.*

291 U.S. at 201 (emphasis added). The Internal Revenue Service has consistently adhered to this same standard in determining the accrual of deductible expenses. *See, e.g.*, Rev. Rul. 72-34, 1972-1 C.B. 132-33.[6]

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[6]The Treasury Regulations with respect to bad debt deductions also illustrate this position. Treasury Regulation § 1.166-1(c), which permits a bad debt deduction only if there is a bona fide debt, also states: "A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid *and enforceable* obligation to pay a fixed or determinable sum of money." (Emphasis added.)

It would be anomalous, if not unconstitutional, to apply the Ninth Circuit's opinion to require Flamingo to *pay* taxes on unenforceable promises to pay but *deny* it a bad debt deduction for uncollectible ones. Yet they may well be a result of the Ninth Circuit's holding, which, according to that Court, leaves Nevada law intact and markers unenforceable at the same time this Treasury Regulation denies a deduction for bad debts on the same ground. *See Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 189 (1934).

In effect, the Ninth Circuit's opinion in this case, if allowed to stand, may overrule *Brown v. Helvering* and herald the end of years of consistent application of the all-events test, which is both fair and easily understood by taxpayers and the Government. For the first time millions — if not billions — of dollars of reserves for future expenses will be deductible. Examples of such reserves for statistically determinable expenses which would be deductible for the first time, and the cases or Internal Revenue Service rulings which heretofore have held such are not, include: reserve for future warranty service [*Bell Electric Co.*, 45 T.C. 158 (1965)]; reserve for self-insurers for future workmen's compensation claims [*Thriftimart, Inc.*, 59 T.C. 598 (1973); Revenue Ruling 70-262, 1970-1 C.B. 122]; reserve for liability for accidents [*Richmond Light & Railroad Co.*, 4 B.T.A. 91 (1926)]; reserve for future required maintenance expense [*World Airways, Inc.*, 62 T.C. 786 (1974), *aff'd* 564 F.2d 886 (9th Cir. 1977)]; reserve by cargo carriers for cargo loss and damage claims [*Gateway Transportation Co., Inc. v. United States*, 77-1 U.S.T.C. ¶9131 (W.D. Wis. 1976) (not officially reported)]; reserve by publishers for returns of unsold books [*J. J. Little & Ives & Co.*, T.C. Memo 1966-1968]; reserve for returns of unsold magazines from distributors [*Readers' Pub. Corp. v. United States*, 40 F.2d 145 (Ct. Cl. 1930)]; reserve for anticipated teaching expenses under contracts for dance instruction [*Villafranca v. Commissioner*, 359 F.2d 849 (6th Cir. 1966)]; reserve for sales commission due when payment received from customers [*Reuben H. Donnelley Corp.*, 22 B.T.A. 175

(1931)]; reserve for return of returnable bags [*LaSalle Portland Cement Co.*, 4 B.T.A. 438 (1926)].[7]

In sum, the Ninth Circuit's approach is in direct conflict with the fundamental principles underlying both this Court's decision in *Brown v. Helvering, supra*, and the publicly announced position of the Internal Revenue Service through rulings, bulletins, and Treasury Regulations.

Because the Ninth Circuit's opinion replaces "legal enforceability" with "mere expectation" as the definitive test for the accrual of income *and* deductions, taxpayers will now have a powerful device for manipulating the *timing* of their deduction of business expenses and for manipulating the *amount* of taxes paid by them. We believe this unhappy prospect was a major factor in causing the Internal Revenue Service to adhere to "legal enforceability" for 60 years of consistent administrative interpretation and in this very case. The Ninth Circuit simply "missed" this point and the profound impact of its decision on the Federal fisc.

CONCLUSION.

For taxpayers in the Ninth Circuit, there no longer need be a liability that is fixed, absolute, and certain for accrual of income and the deduction of expenses. A strong prob-

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[7] In Rev. Rul. 74-69, 1974-1 C.B. 113, the Internal Revenue Service acknowledged that prospective expenses incurred by a gambling machine operator could not be accrued as current expenses because payment of them could not be legally enforced. The Service ruled that a gambling machine operator who gave winning customers coupons redeemable in merchandise from cooperating merchants, whom the operator then paid for the merchandise could *not* deduct the value of the coupons when issued. The operator could deduct the value of the coupons only "when the taxpayer becomes liable to pay the participating merchant for the merchandise used to redeem the coupons." That occurred on redemption.

Inasmuch as Rev. Rul. 74-69 was issued in the same year that Office Decision 1139 was declared obsolete, see page 11, *supra*, for discussion, it is clear that the Commissioner did not change his insistence on legal enforceability as a prerequisite to accrual.

ability, a mere "expectation," may now require accrual, depending on a factfinder's conclusion on the presence or absence, according to the Ninth Circuit, of "unique facts and practical considerations." 664 F.2d at 1389. This is not the way in which the tax laws can be meaningfully acted on by taxpayers or applied by the Internal Revenue Service, nor should it be.

This Court should grant a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit to review its decision in this case.

Respectfully submitted,
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By STEVE MORRIS
Attorneys for Petitioner.

APPENDIX.

Decision of the United States Court of Appeals for the Ninth Circuit.

Flamingo Resort, Inc., Plaintiff-Appellant, v. United States of America, Defendant-Appellee. No. 80-5318.

United States Court of Appeals, Ninth Circuit. Argued and Submitted Oct. 5, 1981. Decided Jan. 7, 1982. Rehearing and Rehearing En Banc Denied April 2, 1982.

Gambling casino appealed from a summary judgment entered by the United States District Court for the District of Nevada, Roger D. Foley, J., 485 F.Supp. 926, in favor of the Government with respect to that portion of assessed deficiency that related exclusively to certain of the casino's receivables. The Court of Appeals, Sneed, Circuit Judge, held that the liability represented by "pit markers" was "fixed," even though gambling debts were not enforceable in state court, and, therefore, the legal, licensed gambling casino was required to accrue the markers.

Judgment affirmed.

Stephen L. Morris, Lionel, Sawyer & Collins, Las Vegas, Nev., for plaintiff-appellant.

Daniel Ross, Washington, D. C., argued, for the U. S.; M. Carr Ferguson, Asst. Atty. Gen., Washington, D. C., on brief.

Appeal from the United States District Court for the District of Nevada.

Before SNEED, TANG and PREGERSON, Circuit Judges.

SNEED, Circuit Judge:

The taxpayer, Flamingo Resort, Inc. (Flamingo), appeals from summary judgment by the district court in favor of the

government. *See Flamingo Resort, Inc. v. United States*, 485 F.Supp. 926 (D.Nev. 1980). The action was instituted initially by Flamingo to recover monies, plus interest, paid by it pursuant to the assertion by the Commissioner of Internal Revenue (Commissioner) of a deficiency with respect to Flamingo's taxable period ending December 31, 1967.

Flamingo sought summary judgment with respect to that portion of the assessed deficiency that related exclusively to certain of the casino's receivables known as "pit markers." Flamingo's motion sought determination of the question of liability only, with the amount subject to later determination. The government also moved for summary judgment with respect to the entire amount in dispute.

The district court, after concluding that the one possible triable issue of material fact would be relevant only if legal enforceability of gambling debts was necessary for the accrual of the receivables in question, granted the government's motion for summary judgment on the ground that accrual was proper despite the absence of legal enforceability. We affirm.

I.
FACTS

The facts are set forth in detail by the district court in its opinion. 485 F.Supp. at 928-30. Briefly, they are as follows. Flamingo is a legal, licensed, gambling casino operating in the State of Nevada. The casino, an accrual basis taxpayer, excluded $676,432.00 of casino receivables in its 1967 tax return. The Commissioner required the accrual of these receivables and authorized an operating reserve fund for bad debts of $130,721. He then assessed a tax deficiency in the amount of $261,942.65, plus interest.

The receivables in dispute arose from uncollected loans extended by Flamingo in the course of its business. In order

to facilitate its gambling operations, Flamingo extended credit to some of its customers. That line of credit was proffered only after an extensive credit check of the patron was conducted by the casino. The customer would sign a "marker" signifying his liability for the sum loaned.[1] Approximately sixty percent of the casino's total play resulted from such credit extensions.

Extensive collection efforts were undertaken on behalf of Flamingo to receive payment of those outstanding casino receivables not repaid prior to the patron's departure. Flamingo's estimates of collectability of those receivables ranged as high as ninety-six percent. The extension of credit and high incidence of payment occurred despite the fact that Nevada does not recognize the legal enforceability of gambling debts. *Corbin v. O'Keefe*, 87 Nev. 189, 484 P.2d 565 (1971).

II.
ANALYSIS

The time of reporting of income of accrual basis taxpayers is governed by the "all events" test. The origins of this test can be traced to *United States v. Anderson*, 269 U.S. 422, 46 S.Ct. 131, 70 L.Ed. 347 (1926). There the Supreme Court held a tax payment for sale of munitions was *deductible* only in the year the sale occurred and not the following year in which the tax was paid. The taxpayer had contended the tax could not be accrued as an expense prior to its assessment and due date. The Court, in rejecting that argument, found "that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it."

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[1]These markers resemble counterchecks and as such indicate to the maker a definite and binding obligation of repayment.

Id. at 441, 46 S.Ct. at 134. This approach was subsequently adopted by the Treasury Department with respect to the accrual of income. "Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Treas.Reg. § 1.451-1(a). *See also* Treas.Reg. § 1446-1(c)(1)(ii).

This case does not involve the question of "reasonable accuracy." Rather the issue is when does the right to receive the income which the "markers" represent become "fixed" for accrual purposes. Commentators and the courts have generally stated that the existence of a definite liability is a prerequisite to the accrual of any obligation. *See* 2 J. Mertens, *The Law of Federal Income Taxation* §§ 12.61-62, 12.66 (rev. ed. 1974); Holland, *Accrual Problems in Tax Accounting*, 48 Mich.L.Rev. 149, 152, 155-56 (1949) [hereinafter cited as Holland]; J. Chommie, *Federal Income Taxation*, (2d ed. 1973) § 83 at 237; *Lucas v. North Texas Lumber Co.*, 281 U.S. 11, 50 S.Ct. 184, 74 L.Ed. 668 (1930) (inasmuch as the vendee did not become unconditionally liable to the vendor for the purchase price in a particular year, no income with respect to the sale accrued to the vendor taxpayer). *But see* Holland, *supra*, at 154 (noting that the extremely strict requirement of *North Texas Lumber Co.* has been relaxed considerably). Flamingo, relying on these authorities, contends that because the persons who gave the "markers" for gambling purposes had no legal obligation to repay the casino, the "markers" being void as a matter of law under *Evans v. Cook*, 11 Nev. 69, 75 (1876), the "liability" they represent was not "fixed." Rather discharge of the "liability" was contingent on the customer's volition. Therefore, Flamingo should not be required to accrue the "markers."

Flamingo also relies on *H. Liebes & Co. v. Commissioner*, 90 F.2d 932 (9th Cir. 1937). There the issue was when should a debt due an accrual basis taxpayer by the government be accrued. The debt was owed by the government as the result of litigation. This court stated:

> We may conclude that income has not accrued to a taxpayer until there arises to him a fixed or unconditional right to receive it. . . .
>
> The complete definition would therefore seem to be that income accrues to a taxpayer, when there arises to him a fixed or unconditional right to receive it, if there is a reasonable expectancy that the right will be converted into money or its equivalent.

Id. at 937-38.

The court held that the right was fixed immediately upon expiration of the time for appeal by the government from the judgment in favor of the taxpayer. At that point there was a reasonable expectancy that the claim would be converted into money even if the funds to satisfy the judgment had not been appropriated. Although *Liebes* clearly establishes that an obligation must be "fixed" and that there be a "reasonable expectancy" of the obligation being converted into cash or its equivalent, it did not hold that in *all* situations the existence of a legal liability to pay is a prerequisite to the existence of a "fixed or unconditional right" to receive payment.

Nor do we believe that this prerequisite universally exists. Support for this position is provided by the line of authority that originates in *Barker v. Magruder*, 95 F.2d 122 (D.C.Cir.1938), a case involving a taxpayer-lender who charged a rate of interest that violated the usury statute of the District of Columbia. The court held that, despite the fact that the statute prohibited the taxpayer from legally enforcing the recovery of any interest, the uncollected usu-

rious interest was properly accruable. It stated, "[t]he correct answer, as we think, depends not so much, as appellants urge, upon the legal right to enforce collection as upon the existing probability of its being received." *Id.* at 123.

The taxpayer's course of dealing with its debtor was considered determinative in fashioning the definition of "fixed."[2] In doing so the *Barker* court can be seen as properly avoiding a rigid definition of the term "fixed" in order to be responsive to unique facts and practical considerations. *See C. A. Durr Packing Co. v. Shaughnessy*, 81 F.Supp. 33, 36 (N.D.N.Y.1948), *aff'd per curiam*, 189 F.2d 260 (2d Cir.), *cert. denied*, 342 U.S. 850, 72 S.Ct. 78, 96 L.Ed. 641 (1951).

Barker addresses a problem analogous to that presented in this case. Both involve a taxpayer attempting, as the district court below aptly phrased it, to "shield its *unsanctioned* operations from the normal incidents of the United States tax laws." 485 F.Supp. at 938 (emphasis added). Flamingo attacks this characterization as both astonishing and wrong and argues that the casino's operations are sanctioned by law. This is not the point the district court was addressing. Its comments were directed at the unsanctioned activity of gambling debt *enforcement*, not the day-to-day legally authorized gambling operations of the appellant. Gambling debt enforcement in Nevada in 1967 and usurious interest enforcement in the District of Columbia at the time

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[2]One commentator has taken the position that the case should be passed over as one departing from the general requirement of the existence of a legal liability prior to the accrual of income. He notes the lendor and obligor were both controlled by the same interest and thus "the presence of a legally enforceable obligation would not serve to increase the probability of payment." Holland, *supra*, at 158. The *Barker* court, however, considered the overall course of dealing between the parties, with the unity of interest being but one factor. *See Travis v. Comm'r*, 406 F.2d 987 (6th Cir. 1969), discussed *infra*.

of *Barker* were each confronted by a bar to the use of the courts. In neither case would the courts have been available to aid enforcement.

Flamingo here, as did the taxpayer in *Barker*, points to certain speculative and potential legal objections to payment available to its debtors. The practical answer emerges from the facts. Few, if any, debtors raise these objections and usually they pay up. Gambling is big business in Nevada. Flamingo and others lawfully engaged in gambling in Nevada who employ the accrual basis in tax accounting should not be permitted to distort that method of accounting merely because the State of Nevada chooses not to permit the use of its courts to collect gambling debts.

Barker does not stand alone. The Court of Claims followed it in a case involving the same taxpayer. *See Barker v. United States*, 26 F.Supp. 1004 (Ct.Cl.1939). The court stated that it was in complete accord with the reasoning of the D. C. Circuit and refused to bar the accrual of income. Another case is *Travis v. Commissioner*, 406 F.2d 987 (6th Cir. 1969). The case involved a statutory prohibition against the collection of monies due under an executory contract for services which have not been rendered. The taxpayer contended such a legal bar should prevent recognition of that income under the accrual basis of accounting prior to the rendition of the services. The court, citing *Barker v. Magruder*, 95 F.2d 122 (D.C.Cir.1938), with approval, noted the Supreme Court in *Commissioner v. Hansen*, 360 U.S. 446, 79 S.Ct. 1270, 3 L.Ed.2d 1360 (1959), had chosen to employ the phrase "fixed right to receive" rather than "enforceable right to recover." It held that accrual was proper when the sums became due and payable even though the service for which the sums were to be paid had not been performed. The *Travis* court believed the practical problems

which would arise if legal enforceability were required necessitated such an interpretation.

We agree and, as did the court in *Travis*, *id.*, emphasize the fact that the taxpayer rarely had to resort to litigation to collect the sums owing to it. Flamingo, as noted earlier, conducted approximately sixty percent of its business through extensions of credit, and its own estimates of collectability on outstanding casino receivables ranged as high as *ninety-six* percent. The lack of legal liability did not interfere with Flamingo's operation and it is doubtful that legal enforceability of the "markers" would or could increase its recovery rate.[3] Under these circumstances, the obligations of Flamingo's patrons are as "fixed" as it is possible to be and, in fact, no less so than those of other businesses. Flamingo should not be heard to argue that it should be taxed differently from other legitimate businesses. Its inability to enforce its "markers" in court is not a sufficient burden to justify such a differential. The debts which the "markers" represent are, therefore, fixed; there is a reasonable expectancy of collection; and no contention has been made that the amounts cannot be determined with reasonable accuracy.[4]

Flamingo puts forth a plethora of cases in support of its contention that legal enforceability of a debt must exist prior to its accrual. These cases, however, are uniformly inapposite. They involve, as the district court correctly noted, factual circumstances not germane to the instant case. *See*

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[3]*Cf.* Holland, *supra*, at 158 (analysis/critique of *Barker v. Magruder*, 95 F.2d 122 (D.C.Cir.1938)), and *see* note 2, *supra*. *See also Barker v. Magruder*, 95 F.2d at 124, (court's emphasis on course of dealing as determinative of when income may be seen as fixed).

[4]The existence of an apparently sufficient reserve fund approved by the Commissioner under I.R.C. § 166(c) in conjunction with the available option of a bad debt deduction, I.R.C. § 166(a), operate to mitigate any legitimate economic hardship to the appellant taxpayer.

Flamingo Resort, Inc. v. United States, 485 F.Supp. at 934.[5] We hasten to add what should be obvious, however. Nothing in this opinion is intended to suggest that legal enforceability is not relevant in determining when a right to income is "fixed" for accrual basis tax accounting purposes. We merely hold that under the circumstances of this case its absence is not controlling.

AFFIRMED.

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[5]Appellant does raise one case which squarely addresses the question now before us. *Desert Palace, Inc. v. Comm'r*, 72 T.C. 1033 (1979). The Tax Court ruled gambling debts were not accruable to a gambling casino until collected. The court, however, did so on the basis of the government's concession of that issue at trial, and astutely commented that the issue was more complex than the parties perceived, citing the *Travis* and *Barker* decisions, 72 T.C. at 1050 & n.8. No such concession was made in the case now before us. And even if such a concession was made by the government, we are not bound by a party's erroneous view of the law. We agree with the district court that the Tax Court holding should not be applied here.

Memorandum Opinion Granting Defendant's Motion for Summary Judgment and Denying Plaintiff's Motion for Partial Summary Judgment.

In the United States District Court for the District of Nevada.

Flamingo Resort, Inc.. Plaintiff, vs. United States of America, Defendant. Civil LV 76-19 RDF.

Filed February 26, 1980.

THE FACTS

Flamingo Resort, Inc. (Flamingo), was incorporated on August 17, 1967, and at all times relevant to this case was the owner and operator of a gaming resort in Las Vegas, Nevada. The Flamingo kept its books and reported its taxes on the accrual basis of accounting.

Flamingo filed an income tax return for the short taxable year ended December 31, 1967. The return showed a taxable income of $22,500 and, because of certain tax credits, no tax liability. Following an audit and other administrative proceedings, the Commissioner of Internal Revenue asserted a proposed deficiency in the amount of $265,034.34. Of that amount, Flamingo agreed that $3,091.69 was properly due as the result of adjustments that raised taxable income to $31,075. Flamingo continued to object to the inclusion in income of $545,711 represented by "casino receivables." While the total "casino receivables" on the books of Flamingo amounted to $676,432, the Commissioner allowed a loss deduction of $130,721 for uncollectible accounts. The Flamingo, however, paid the entire amount of the asserted deficiency, plus interest, on December 22, 1975. Then the Flamingo filed a claim for refund of an overpayment in the amount of $261,942.65, plus interest. When the claim was denied by the Internal Revenue Service, the

Flamingo timely commenced this action to recover the alleged overpayment.

From August through December 1967, the taxable period in question, Flamingo operated crap games, twenty-one games and roulette wheels in the casino portion of its business. Patrons generally gambled chips at these games. Under normal circumstances, a patron would obtain chips either through the exchange of cash or a marker, which was essentially a countercheck signed by the patron in the amount of the chips transferred to him. This exchange would take place either in the "pit" area, where the games were being conducted, or at the casino cage, where chips would be exchanged by the casino for cash or counterchecks. Before credit would be extended to a patron, Flamingo conducted extensive credit checks and then established a line of credit allowable to that patron. Extensions of credit during the course of play were subject to controls by Flamingo personnel and were recorded in the pit area and reconciled at the cashier's cage. It is estimated that sixty percent of the total play in the casino resulted from extensions of credit and, as a result, such extensions are absolutely essential to the success of the Flamingo's business.

A patron was expected to settle his liability shortly after concluding his play, and the vast majority of credit extensions were satisfied on that basis. If a patron had not satisfied his marker liability by the close of his stay at the hotel, the marker became classified as a casino receivable. Extensive collection activities were undertaken with respect to these receivables and actual payment was received on the vast majority of them. The record indicates that the Flamingo's estimates of collectibility on outstanding casino receivables ranged as high as 96 percent.

In the Flamingo operation during the period in question, the marker was in the form of a countercheck with blanks

left for the name of the bank and account number. In practice, the patron only signed his name after the amount had been entered without completing the blanks for bank information. The necessary information was available, however, on the credit application kept in the casino credit office. It was thus possible for the Flamingo to complete the counterchecks and submit them for payment to the makers' banks.

Casino receivables, including markers, checks given in payment for the markers that were returned for insufficient funds, and checks given in payment for the markers that were post-dated beyond the close of the taxable period on December 31, 1967, net of a reserve for potential uncollectibility, were included on the Flamingo's financial statement as revenue and as assets.

In virtually all cases, a patron would receive chips in exchange for his marker or countercheck. But the patron could gamble both with chips and, to a limited degree, with cash. Any winnings would, however, be paid to the patron in chips. The inventory for each game at the casino consisted of chips. As the game progressed, additional chips would be transferred to the games from the cage to "fill" the inventory. The casino's net gambling revenue at a game for a given eight-hour shift would constitute the difference between the total volume of play at the table, which is called the "drop" (consisting of cash, markers and foreign chips), and the total "fill" at the table (opening chip inventory plus "fill," less closing inventory). For the short taxable period in issue, the Flamingo showed a "gross games revenue," drop minus fill, of $3,967,600 on a total play of $20,102,429. The Flamingo also accounted for and controlled calculation of its gaming revenue by reflecting adjustments in its "bankroll." This is essentially the book inventory maintained in the cage and, at the beginning of

an accounting period, will consist of cash, chips, unpaid markers and chips from other casinos, foreign chips that were played in the Flamingo casino. The changing composition and amount of the bankroll gauges the casino's wins and losses, but the play of chips by gambling patrons is the activity that determines these amounts.

Chips in the patrons' hands represented outstanding obligations which the Flamingo always recognized. Once a patron obtained chips, he could expend them through gambling or by purchasing hotel, restaurant and bar services at either the Flamigo's business establishment or at other casinos in Las Vegas. In 1967 the casinos conducted a regular exchange of their chips at face value and, in addition, cash payments would be made, as necessary, to equalize the exchange.

In accordance with generally accepted accounting principles, the Flamingo prepared its financial statements on the basis of the accrual method of accounting. The amount of "casino receivables," less a reserve for doubtful accounts, was included in income. For tax purposes, however, Flamingo reduced its gross gaming receipts by excluding the face amount of the markers outstanding. The Flamingo argues that these are unenforceable gambling debts and are therefore not properly accruable as taxable income. The Government had not contested the Flamingo's claim that the markers may be legally unenforceable, but urges that the markers nevertheless represent income that is properly accruable for purposes of determining taxable income. Moreover, the Government contends that such accrual is mandated by the requirement that a taxpayer's method of accounting "clearly reflect income." Exclusion of the markers, argues the Government, allows Flamingo to distort income by postponing recognition of this income which

results in a mismatching of income and expenses related thereto.

The Flamingo has moved for summary judgment with respect to that portion of the claim that relates exclusively to "pit markers." The motion seeks determination of the question of liability only, with the amount subject to subsequent determination. The Government has moved for summary judgment in its favor with respect to the entire controversy. If there are any genuine issues of material fact, they concern only the question of a "gambling purpose" with respect to the possible existence of cage markers and checks included in the "casino receivables" account. That issue would be relevant only if it were determined that legal enforceability is necessary for the accrual of the income in question.

I.
Jurisdiction

This Court has jurisdiction, 28 U.S.C. § 1346(a)(1).

II.
Gambling Debts Under Nevada Law.

This entire controversy arises only because of an apparent quirk of Nevada law. Despite the licensing and taxing of gaming by the State of Nevada and the state's economic dependence upon gambling, the Nevada courts have consistently refused to recognize any legally enforceable rights arising out of a gambling transaction short of the actual transfer of money.[1] The Supreme Court of the State of

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[1]The decisions cover a one hundred year period. Corbin v. O'Keefe, 87 Nev. 189, 484 P.2d 565 (1971) (per curiam); Wolpert v. Knight, 74 Nev. 322, 330 P.2d 1023 (1958); Weisbrod v. Fremont Hotel, Inc., 74 Nev. 227, 326 P.2d 1104 (1958) (per curiam); West Indies, Inc. v. First National Bank of Nevada, 67 Nev. 13, 214 P.2d 144 (1950); Craig v. Harrah, 66 Nev. 1, 201 P.2d 1081 (1949); Menardi v. Wacker, 32 Nev. 169, 105 P. 287 (1909); J. E. Burke & Co. v. Buck, 31 Nev. 74, 99 P. 1078 (1909); Evans v. Cook, 11 Nev. 69 (1876); Scott v. Courtney, 7 Nev. 419 (1872).

Nevada early held that the statute of 9 Anne, ch. 14, § 1, is part of the law of Nevada. *J. E. Burke & Co. v. Buck*, 31 Nev. 74, 80, 99 P. 1078, 1080 (1909); *Evans v. Cook*, 11 Nev. 69, 75 (1876). The language of the statute is clear to the effect that any instruments or conveyances made to cover gambling losses or to advance money for betting are void and not merely voidable.[2] The same rule applies whether the claim is asserted by a gambling establishment, *Craig v. Harrah*, 66 Nev. 1, 201 P.2d 1081 (1949), or against one, *Weisbrod v. Fremont Hotel, Inc.*, 74 Nev. 227, 326 P.2d 1104 (1958). The taint of a gambling transaction also applies to a check written to cover a gambling loss. *West Indies, Inc. v. First National Bank of Nevada*, 67 Nev. 13, 214 P.2d 144 (1950); *Menardi v. Wacker*, 32 Nev. 169, 105 P.2d 287 (1909). The rule also prevents an effective assignment of a negotiable instrument. *J. E. Burke & Co. v. Buck*, 31 Nev. 74, 99 P. 1078 (1909).

The difficult cases are those in which instruments or conveyances, valid on their face, are asserted to have been made in furtherance of a gambling purpose. The Nevada court has developed certain presumptions to aid the courts' navigation in these unsure waters.

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[2] "That all notes, bills, bonds, judgments, mortgages, or other securities or conveyances whatsoever given, granted, drawn, or entered into, or executed by any person or persons whatsoever, where the whole, or any part of the consideration of such conveyances or securities shall be for any money, or other valuable thing whatsoever, won by gaming or playing at cards, dice, tables, tennis, bowls, or other game or games whatsoever, or by betting on the sides or hands of such as do game at any of the games aforesaid, or for the reimbursing or repaying any money knowingly lent or advanced for such gaming or betting as aforesaid, or lent or advanced at the time and place of such play, to any person or persons so gaming or betting as aforesaid, or that shall, during such play, so play or bet, shall be utterly void, frustrated, and of no effect, to all intents and purposes whatsoever."

> "In determining the purpose [behind the indebtedness], the significance and relevancy of the surrounding circumstances and environment are readily apparent. If the advancement was made in a gambling establishment in full operation, by the proprietor or his agent, to one then, or immediately prior thereto, engaged in gambling and who ran short of money, the game still being in progress, or if his conversation or the circumstances indicated he intended to resume playing, the purpose of the advancement becomes clear. On the other hand, if the advancement was at a different place than a gambling establishment, or if same was not made at a time when the recipient had been recently playing, and some other, legitimate, purpose is stated by the recipient, then no presumption or inference that the advancement was for a gambling purpose is justifiable from such circumstances." *Craig v. Harrah*, 66 Nev. at 6, 201 P.2d at 1084.

In *Wolpert v. Knight*, 74 Nev. 322, 330 P.2d 1023 (1958), the defendant issued a $2,500 check to cover five previously issued $500 checks, four of which had been cashed at the cashier's desk and one of which was written to obtain gambling chips. There was testimony that an undetermined amount of the money had been spent gambling, but that other amounts were used to buy drinks, were given to friends, etc. Relying on the *Craig* case, the Court upheld the determination that the defendant was liable as to the $2,000 representing the checks cashed other than at the gaming tables. Thus, the burden of proving a gambling purpose is on the party seeking to avoid liability thereon, but there is a presumption of gambling purpose where the transaction occurs in proximity to the gambling itself in terms of both time and space.

III.

Accrual of Income for Tax Purposes.

The determination as to when income is properly recognized for tax purposes is governed by § 451 of the Internal Revenue Code of 1954, 26 U.S.C. § 451. Both parties accept the following rule, taken from the regulations, as the starting point for discussion of the issues in this case:

> "Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Treas. Regs. § 1.451-1(a).

See also Treas. Regs. § 1.446-1(c)(1)(ii). The rule is often referred to as the "all events test." The regulation sets two criteria, both of which must be met if the taxpayer is to be required to include an item in taxable income. First, the right to receive the income must be fixed. Second, the amount of the income must be reasonably ascertainable. In this case, there is no real controversy as to the second prong of the test. Each marker is for a specific dollar amount and there are no contingencies that could alter the amount of the obligation. Moreover, the Flamingo can establish with reasonable accuracy the amount that will ultimately be collected on the markers. The controversy in this case concerns whether or not the markers represent a "fixed right" to receive income. The plaintiff contends that this means a legally enforceable right, while the defendant maintains that it means something less absolute.

The Tax Court of the United States recently had occasion to consider a case involving the same issue with respect to taxation of markers of another Las Vegas casino (Caesars Palace). The case is *Desert Palace, Inc. v. Commissioner*, 72 T.C. No. 85 (Docket No. 8531-74, September 11, 1979). Based upon some alleged concession therein made by the

Commissioner, it appears that the Tax Court held that where a marker given by a patron of a gambling casino would be found to be a gambling debt under state law and therefore unenforceable, such marker would not represent accruable income until actually paid. As explained infra, this Court does not agree with the Tax Court's conclusion and finds it inconsistent with earlier Tax Court decisions discussed infra.

The "all events" test has its origin in an early Supreme Court case dealing with the availability of a deduction for taxes that had not yet been assessed and thus were not due. The Court noted that accrual basis accounting was permitted for income tax purposes to permit taxpayers to "make their returns according to scientific accounting principles," specifically the matching of revenues and expenses. *United States v. Anderson*, 269 U.S. 422, 440, 70 L.Ed. 347, 350 (1926). Rejecting the contention that an expense for taxes could not accrue as a tax deduction until the tax became due and payable, the Supreme Court said:

> "In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that *in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it*. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books. In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the taxes had accrued."
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> Id. at 441, 70 L.Ed. at 351 (emphasis added).

At that point in time, it was clear that accounting for business purposes was essentially accepted as accounting for tax pur-

poses. This view has changed somewhat over the years. Particularly with respect to the principle of matching revenues and expenses, business and tax accounting are recognized as obtaining divergent results in some instances. The main distinction is that tax accounting requires more certainty than does financial accounting. See *Eastman Kodak Co. v. United States*, 534 F.2d 252, 255 (Ct. Cl. 1976) (en banc). But it is by no means clear that this distinction turns on the existence or not of legal enforceability.

In *H. Liebes & Co. v. Commissioner*, 90 F.2d 932, 936-38 (9th Cir. 1937), the Ninth Circuit Court of Appeals reviewed the development of the accrual concept for income tax accounting purposes. Courts have used various words and phrases to describe the situation in which accrual of income is proper: "unconditional liability,"[3] a "right to payment,"[4] "fixed right to receive,"[5] "uncontested and certain,"[6] and "definitely ascertained as to its amount, and acknowledged to be due."[7] Synthesizing the cases reviewed, the *Liebes* Court concluded:

> "From the above expressions, it is apparent that the general definition of ["]accrued" is limited when taken in connection with income returns. We may conclude that income has not accrued to a taxpayer until there arises to him a fixed or unconditional right to receive it." 90 F.2d at 937.

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[3]Lucas v. North Texas Lumber Co., 281 U.S. 11, 13, 50 S.Ct. 177, 179, 74 L.Ed. 518 (1930).

[4]Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 295, 52 S.Ct. 529, 530, 76 L.Ed. 1111 (1932).

[5]Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 184, 54 S.Ct. 644, 645, 78 L.Ed. 1200 (1934).

[6]United States v. Safety Car Heating & Lighting Co., 297 U.S. 88, 93-94, 56 S.Ct. 353, 356, 80 L.Ed. 500 (1936).

[7]Lichtenberger-Ferguson Co. v. Welch, 54 F.2d 570, 572 (9th Cir. 1931).

What emerges from these statements is that the key concept for accrual of income is that the right to receive income must be *fixed or unconditional*. This comports with the plain meaning of the language used in the regulations. The reference to the occurrence of "all events" seems to denote the absence of a contingency on the right to receive the income.[8]

The plaintiff here argues that the markers do not represent an "unconditional right" to receive income because ultimate collection depends—is contingent—upon a voluntary act of the maker of each obligation. This argument ignores, however, the important distinction between a "right to receive" and actual receipt which forms the very basis for disparate treatment under the accrual and the cash methods of accounting. Certainty of receipt has never been a requirement for the accrual of income. Indeed, the allowance of a deduction to create a reserve for doubtful accounts recognizes that accrued income may never actually be received. In the sense that the plaintiff urges here, no right to receive income would be "unconditional"; there is always the possibility that a given obligation will become uncollectible in one way or another. Indeed, the Supreme Court has expressly held that the intervention of the defense of bankruptcy is not sufficient to preclude recognition of income even when it occurs in the same year as the obligation is incurred. See *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 54 S.Ct. 644, 78 L.Ed. 1200 (1934). In *Liebes*, supra, the Ninth Circuit concluded that,

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[8]In a slightly different context (the determination of a decedent's taxable income), the Fourth Circuit speaks of the absence of a contingency as an important element of accruable income and notes that "fixed" is to be contrasted with "inchoate" and "in the process of becoming." Helvering v. McGlue's Estate, 119 F.2d 167, 170 (4th Cir. 1941).

given a fixed or unconditional right to receive income, accrual is proper so long as there is a "*reasonable expectancy*" that the income will be ultimately received in the form of cash or its equivalent. 90 F.2d at 937-38. Although this creates an exception to the general accrual principles in those situations in which there is no reasonable expectancy of collection, it is clear that the uncertainty as to collection must be substantial and not simply technical. The exception is strictly construed. See *Stephens Marine, Inc. v. Commissioner*, 430 F.2d 679, 685 (9th Cir. 1970).

Of the cases cited by the plaintiff for the proposition that legal enforceability is a requirement for the accrual of income, only three actually use the word "enforceable" in that context. In *Maryland Shipbuilders & Drydock Co. v. United States*, 409 F.2d 1363, 1367 (Ct. Cl. 1969), it was said:

> "When the cases speak of 'a fixed right to receive' an amount as the touchstone of its accruability for federal tax purposes, they plainly comprehend a 'right' *that is enforceable with no strings attached*—not a 'right' the exercise of which must be purchased by the beneficiary with the surrender of some other related and valuable right such as, in this case, the right to pursue the possibilities for an additional recovery under the SRL policies." (emphasis added.)

The key portion of this excerpt is "with no strings attached" and not the word "enforceable." That case involved the recognition as income of insurance proceeds to cover lost earnings. The taxpayer's loss was covered by multiple policies and the insurer had offered to pay the "total loss" amount under one policy in return for an agreement from the taxpayer to forego any recovery under other policies. The Commissioner had sought to include that amount in the taxpayer's income as an accrued item. The Court of Claims

decided that there was no "fixed right" to receive that income because the recovery was still subject to determination either through negotiations or by resort to the courts. The basis of the decision was *not* that the taxpayer did not have an "enforceable right" to the amount in question. Indeed, it may well have been that there was a "legally enforceable" obligation on the part of the insurer. But that recovery was not settled and therefore not sufficiently certain to justify accrual for tax purposes.

In a somewhat earlier case, the Court of Claims asserted that "[t]he cases uniformly agree that before an item of income may be accrued, there must be a fixed, determined and enforceable right to receive a reasonably ascertainable amount." *Breeze Corps., Inc. v. United States*, 117 F.Supp. 404, 407 (Ct. Cl. 1954). Examination of the cases cited in the footnote to this statement reveals not a single case holding legal enforceability to be a necessary element of a "fixed right" to receive income. The *Breeze* case itself turned on the fact that the amount of income due the taxpayer on a procurement contract was subject to redetermination by the Navy before final settlement was made.

Finally, the language of *Cuba Railroad Co.*, 9 T.C. 211 (1947), seems to indicate that enforceability is necessary for the accrual of income. There, the taxpayer had fully rendered services under contract with the Cuban government, which admitted the existence of the full liability. Nevertheless, the Cuban legislature consistently appropriated an amount insufficient to cover all obligations of the government. The amount appropriated for transportation services was apportioned among various carriers. There was no means of enforcing the full amount of the debt. The Tax Court said:

> "The petitioner had an unenforceable claim. Collection was apparently at the mercy of the political

> whims of future Cuban administrations. The evidence as a whole shows that there was real doubt and uncertainty at the end of the taxable year as to whether any of the amount due and unpaid would ever be paid. A taxpayer, in such circumstances, is not required to accrue an item like this as income and pay income tax thereon, but is permitted to wait until the uncertainty is removed in some way."
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> 9 T.C. at 215.

Considering the context of this reference to enforceability, however, indicates that this case falls within the area in which there is no reasonable expectancy that the contract price would be recovered. Therefore, under the *Liebes* standard, it was not accruable as income. Unenforceability was simply a factor contributing to the "doubt and uncertainty" as to the expectancy of ultimate collectibility. It is also significant that the Court spoke of "*real*" uncertainty.

While it might be possible to distinguish each of the cases relied on by the plaintiff, a completely satisfactory treatment would require a tedious exposition of factual material and legal reasoning that would be too lengthy to warrant the effort. Briefly, however, those cases in which income was determined not to be accruable fall into three basic categories: (1) those in which the taxpayer still had to perform some act in order to bind the other party to the obligation,[9] (2) those in which the claim to income was the subject of *actual* controversy, either as to liability or amount, during

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[9]Lucas v. North Texas Lumber Co., 281 U.S. 11, 74 L.Ed. 668 (1930) (no unconditional liability on an executory contract for sale of property until closure); C. A. Durr Packing Co. v. Shaughnessy, 81 F.Supp. 33 (N.D.N.Y. 1948), aff'd per curiam, 189 F.2d 260 (2d Cir. 1951), cert. denied, 342 U.S. 850 (1951) (statute on which claim was based required "establishment" of the right in administrative proceedings).

the taxable year in question,[10] and (3) those in which contractual income was subject to final determination upon completion.[11] This case fits into none of these groupings. In some cases in the last two categories, it is clear that the courts did not adequately distinguish between the two parts of the test for accrual of income. Although some cases speak in terms of "fixed rights", it is clear that the real issue in the case involves the extent to which the amount is reasonably ascertainable.

In contrast with those cases cited by the plaintiff, there are cases that have expressly held that legal enforceability is not a prerequisite to the accrual of income.[12]

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[10]United States v. Safety Car Heating & Lighting Co., 297 U.S. 88, 56 S.Ct. 353, 80 L.Ed. 500 (1936); North American Oil Consolidated v. Burnet, 286 U.S. 417, 76 L.Ed. 1197 (1932); Commissioner v. Henry Hess Co., 210 F.2d 553 (9th Cir. 1954); H. Liebes & Co. v. Commissioner, 90 F.2d 932 (9th Cir. 1937); Maryland Shipbuilders & Drydock Co. v. United States, 409 F.2d 1363 (Ct. Cl. 1969); Foster Wheeler Corp., 20 T.C. 15 (1953); Georgia School-book Depository, Inc., 1 T.C. 463 (1943) (dicta).

[11]United States Cartridge Co. v. United States, 284 U.S. 511, 52 S.Ct. 243, 76 L.Ed. 431 (1932); Stephens Marine, Inc. v. Commissioner, 430 F.2d 679 (9th Cir. 1970); United States v. Harmon, 205 F.2d 919 (10th Cir. 1953); Marquardt Corp., 39 T.C. 443 (1962), Globe Corp., 20 T.C. 299 (1953). Cf. Cuba Railroad Co., 9 T.C. 211 (1947) (amount actually payable by debtor subject to redetermination despite admitted liability for full contract price).

[12]In a recent en banc decision, the Court of Claims explicitly disavowed any requirement of legal enforceability with respect to deductions for accrued expenses:

> ". . . . The 'all events' test . . . looks to a liability that is so fixed that the fact of liability is certain and the amount thereof reasonably ascertainable, *although not necessarily legally enforceable*. The 'all events' test thus allows deductions when the taxpayer has a special kind of knowledge which gives him enough facts to demonstrate the absolute necessity of paying an expense at some future date without regard to such matters as actual payment taking place, existence of legal liability, or accrual."
> Eastman Kodak Co. v. United States, 534 F.2d 252, 257 (Ct. Cl. 1976) (emphasis added).

The "all events" test applicable to deductibility of expenses is similar to that for recognition of income. See Treas. Regs. § 1.461-1(a)(2).

The case most closely analogous to the one presently before the Court involved the accrual of usurious interest. In *Barker v. Magruder*, 95 F.2d 122 (D.C. Cir. 1938), the Court held that the lender must accrue as income the amount of interest due on the face of a note, despite the fact that under the usury statute of the District of Columbia the lender was entitled only to the return of the principal and no interest whatsoever. The Court concluded that "[t]he correct answer . . . depends not so much . . . upon the legal right to enforce collection as upon the existing probability of its being received." 95 F.2d at 123. In an almost identical case, involving the same lender, the Court of Claims followed the Circuit Court and said: "[T]axability is not affected because of its illegality. If in a subsequent year the amount becomes uncollectible or a loss is sustained in respect thereof, a deduction on account thereof is then allowable."[13] *Barker*

The Tax Court has also rejected the argument that legal enforceability is a prerequisite to deduction of accrued expenses. In a case involving a corporate resolution to pay a widow's pension, that Court said: "there is no requirement that there must be an underlying legal liability before a definite and fixed obligation to make an expenditure can qualify as an accrued 'ordinary and necessary' business expense . . . ." Champion Spark Plug Co., 30 T.C. 295, 298 (1958).

[13]The availability of an offsetting deduction for uncollectible accounts is important in that it satisfies the need to construe the tax law in an unoppressive way while maintaining the concept of the calendar (or fiscal) year of accounting. But even in a situation where such a deduction would have been unavailable, the Fourth Circuit Court of Appeals refused to adopt a legal enforceability requirement urged by the taxpayer. In *Knight Newspapers v. Commissioner*, 143 F.2d 1007 (4th Cir. 1944), the taxpayer argued that a dividend declared in violation of state law and contrary to the terms of the declaring corporation's preferred stock certificates was at least voidable, if not void, and therefore not properly accruable. The taxpayer had in fact been required to return the dividend during the subsequent year. Moreover, recognition of the income represented by the dividend would have resulted in the assessment of a personal holding company surtax, which would not be recoverable by deduction in a subsequent year. Nevertheless, rather than adopt the "legal unenforceability" rationale urged by the taxpayer, the Fourth Circuit invoked the constructive trust doctrine to avoid an unjust result.

(footnote continued on following page)

v. United States, 26 F.Supp. 1004, 1006 (Ct. Cl. 1939).[14] The Court of Claims reasoned that the usury statute was enacted as a protection for borrowers and that the taxpayer should not be permitted to invoke his own wrongdoing as a means of avoiding taxes that would be due in the absence of the statute.

In *Travis v. Commissioner*, 406 F.2d 987 (6th Cir. 1969), the taxpayer failed to accrue as income installments due on contracts for services that had yet to be performed. The taxpayer argued that applicable state law precluded recovery on executory contracts and therefore there was no fixed right to receive the income. The Sixth Circuit rejected the argument that the rule required a legally enforceable right. The Court recognized that precedent it relied on was less

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But the Court intimated that a different result might well inhere where there was no similar potential for injustice.

> "It was said [in National City Bank v. Helvering, 98 F.2d 93, 96 (2d Cir. 1938)] that 'although taxes are public duties attached to the ownership of property, the state should be able to exact their performance without being compelled to take sides in private controversies,' and also that 'collection of the revenue cannot be delayed, nor should the Treasury be compelled to decide when a possessor's claims are without legal warrant. If he holds with claim of right, he should be taxable as an owner, regardless of any infirmity of his title; no other doctrine is practically possible, and no injustice can result.' "
> 143 F.2d at 1009.

Of course, the *National City Bank* case stands for the familar "claim of right" doctrine applicable to situations in which money or its equivalent is actually received, and therefore is arguably inapplicable to the issue of accrual of income. The rationale, however, is clearly applicable: in the absence of potential injustice, the administration of the tax laws of the United States should not include inquiry into the legal validity of taxpayers' claims on assets.

[14]See also Tharp v. Commissioner, 31 T.C.M. (CCH) 22 (1972) (while not at issue in the case, unenforceable usurious interest was accrued and returned as income); Herberger v. Commissioner, 9 T.C.M. (CCH) 542 (1950), aff'd, 195 F.2d 293 (9th Cir. 1952) (accrual required despite unenforceability due to price in excess of governmentally imposed price ceilings).

than ironclad, but adopted the rule of *Barker v. Magruder*, supra.

> "We do not believe that when the Supreme Court spoke of 'the right to receive income' in an accrual method of accounting income tax case that it intended to equate that phrase in all respects with 'a legally enforceable right to receive income.' In Commissioner of Internal Revenue v. Hansen, 360 U.S. 446, 79 S.Ct. 1270, 3 L.Ed. 2d 1360 (1959), the Supreme Court specifically rejected a contention that a 'presently enforceable right to recover' was essential to require inclusion of income. The Court said:
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> > 'But the question is not whether the taxpayers can presently recover their reserves, for, as stated, it is the time of acquisition of the *fixed right to receive* the reserves and not the time of their *actual receipt* that determines whether or not the reserves have accrued and are taxable.' Commissioner of Internal Revenue v. Hansen, supra at 464, 79 S.Ct. at 1280. (Emphasis in original.)
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> "We recognize, of course, that this language taken in context might be argued as expressing rejection primarily of the term 'presently.' But we regard it as significant also that the Court having before it the term 'enforceable right to recover' did not adopt such language and did emphasize the term 'fixed right to receive.'
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> "There are so many practical problems which would be engendered in tax cases if the term 'legally enforceable' was employed that we tend to construe the choice of language referred to above as significant.
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> "We agree with the United States Court of Appeals for the District of Columbia . . . ."
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> 406 F.2d at 989-90.

The Court noted that to hold otherwise would ignore the realities of the situation.

> "This court, in a quite different income tax case, set this standard for interpretation of relevant facts, 'the transaction must be viewed as a whole and in the light of realism and practicality.' Commissioner of Internal Revenue v. Segall, 114 F.2d 706, 709 (6th Cir.) cert. denied, 313 U.S. 562, 61 S.Ct. 838, 85 L.Ed. 1522 (1940).
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> "Appellants wrote these contracts for dance lessons so as to convince their patrons that they assumed a binding obligation for the payment, whether the lesson had ever been given or not. This record indicates that many such payments were made in accord with the terms of the contracts. It appears, in fact, that appellants rarely had recourse to litigation. We believe that under the language of the contracts the right to income became fixed for accounting purposes under the accrual method when the payments became due and payable under the terms of the contract. Failure to include such accounts as income when they were due and payable meant that appellants' tax return failed clearly to reflect income."
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> 406 F.2d at 990 (footnotes omitted).

In *Schlude v. Commissioner*, 372 U.S. 128, 83 S.Ct. 601, 9 L.Ed. 2d 633 (1963), the Supreme Court required accrual of income under a similar contract. The Supreme Court did not address, however, the issue of "legal enforceability" apparently because the issue was raised for the first time on appeal. 406 F.2d at 989.

If anything is clear from the foregoing cases, it is that the courts have not developed a formula that can be applied mechanically to any given fact situation to determine whether accrual is proper or not. Rather, the courts have attempted to apply the "all events" test in a manner that

recognizes the realities of a given transaction. As one court noted, whether a right is fixed and the amount thereof determinable depends upon "a practical rather than a legal test." *C. A. Durr Packing Co. v. Shaughnessy*, 81 F.Supp. 33, 36 (N.D.N.Y. 1948), aff'd per curiam, 189 F.2d 260 (2d Cir.), cert. denied, 342 U.S. 850 (1951).

IV.

Accrual of Income from Gambling on Credit

Aside from the recent *Desert Palace* case, there is only one reported federal case that has dealt directly with any tax effect of a gambling debt. *United States v. Hall*, 307 F.2d 238 (10th Cir. 1962), involved the settlement of a gambling debt incurred in a Las Vegas casino. The taxpayer had borrowed large sums of money with which to gamble on the basis of a guarantee of one of the owners of the casino. The casino owner had settled the debt with the casino and the taxpayer transferred an interest in a cattle herd to the casino owner in settlement between them. The controversy arose as to whether the taxpayer must report as income the amount by which the debt exceeded his basis in the cattle. The Court, however, treated the transaction as if the cattle had been sold at fair market value and the cash proceeds of the sale had been used to pay off the gambling debt, the amount of which was the subject of some controversy.

The plaintiff asserts that the Tenth Circuit in *Hall* ruled that a gambling debt is a nullity for tax purposes. This characterization plainly goes too far. While the Court did say that the amount of the gambling debt had "no significance for tax purposes," that conclusion was expressly limited to the circumstances of that particular case. 307 F.2d at 242. Moreover, the Court went on to say:

> "The elimination of a gambling debt is, however, a transaction that may have tax consequences independent of the *amount* of the debt and certainly cannot be used as a tool to avoid a tax incident which is shielded only by the screen of its unenforceable origin."

Id. (emphasis in original.)

In relying on the holding of *Hall*, the Government has argued that the Flamingo's income arises from the cancellation of indebtedness every time the casino wins one of the chips given out in exchange for the markers. Despite the Government's novel, though convoluted, theory, *Hall* is simply inapplicable to the case presently before the Court. That case involved a gambling debt transaction which in no way resembles the creation of a marker. First of all, it deals with the settlement of the loan. Second, it deals with the transaction from the perspective of the debtor, rather than the creditor. What would really interest this Court is how the casino in *Hall* treated the gambling income. Finally, the Government's argument only serves to complicate matters. The chips are as unenforceable as the markers and therefore the shift of focus does nothing to eliminate the conceptual difficulty of the issue. Indeed, it was the extinguishment of an unenforceable obligation that gave the Tenth Circuit such problems. Moreover, it is fatuous to characterize the cancellation of the chip "indebtedness" as a sale at fair market value of "gambling services," even ignoring the problems such valuation might entail. In sum, the Government's new theory stretches the "cancellation of indebtedness" doctrine far beyond its reasonable application. This goes directly against the rationale of *Hall* that warns against applying "mechanical standards which smother the reality of a particular transaction." 307 F.2d at 241. The use of chips in the gaming area is merely a convenience; the existence of any "liability" on them is, as the plaintiff points

out, "transitory." The existence of this temporary debtor-creditor relationship is important only at the beginning and end of the accounting period. The method of accounting for income employed by Flamingo completely accounts for this effect of the chips on income.[15] The most which can be said for the Government's argument is that it shows, from another perspective, that the Flamingo's income is generated at the time the gambling occurs, not when a marker is either executed or paid. This does not, however, solve the tax accounting problem of determining at what point that income must be recognized.

The *Hall* decision does, however, provide a good starting point for the discussion of the issue before this Court. While the factual setting of *Hall* is entirely different from that here, the Tenth Circuit seized upon an important policy consideration that is applicable to the issue of accruing marker income. That principle is that the mere fact of "legal unenforceability" should not be used as a means to avoid an otherwise applicable tax incident. This is related to the rationale of *Barker v. United States, supra,* that a taxpayer should not be allowed to take advantage of his own wrongdoing in order to avoid taxation. While the Nevada courts have never cogently explained the rationale behind their continued adherence to the old English statute regarding

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[15]The chips are important in the calculation of gross gaming revenue for two reasons. First, all bets lost by the casino are paid out in chips, and therefore revenue may be calculated without requiring all gamblers to cash the chips at the close of the accounting period. Second, chips also provide an offset against the amount of the "drop" that has not actually been won by the casino. Both of these amounts are accounted for in the calculation of the "fill." Thus, outstanding chips have no theoretical effect on the casino income. There may be an incidental effect, however, if chips are never redeemed because they are irretrievably lost, destroyed or retained as a souvenir or good luck token. The Government has not suggested how the amount of any such income due to "leakage" from the casino bankroll might be calculated.

gambling indebtedness, and despite the fact that such a rule seems strangely incongruous in light of Nevada's economic dependence upon its gaming industry, the existence of the rule indicates that gambling on credit, or the facilitation thereof, is considered morally reprehensible and thus constitutes wrongdoing. Like the usury statute in *Barker*, the unenforceability of gambling debts is for the protection of the public. Thus, the Flamingo should not be allowed to use the rule to further shield its unsanctioned operations from the normal incidents of the United States tax laws.

On the other hand, there seems to be something inherently unfair about imposing taxes on "income" that may never be received. This objection is met, however, by the availability of a bad debt or loss deduction if the receivable actually becomes uncollectible. See *Barker v. United States*, supra. The Government here has allowed a deduction to create a reserve for doubtful accounts in accordance with regular accrual accounting principles. There is nothing to indicate that should the reserve prove inadequate, additional future deductions would not be allowed to eliminate the potential for injustice. Moreover, in cases of other types of wrongdoing, such as embezzlement or fraud, the "claim of right" doctrine is consistently applied to require recognition of clearly illegal income to which the taxpayer has no legitimate claim and indeed may have to return. See, e.g., *National City Bank v. Helvering*, 98 F.2d 93 (2d Cir. 1938).

Applying the principles enunciated by the Ninth Circuit in *H. Liebes & Co. v. Commissioner*, supra, to the facts of this case, viewed "in the light of realism and practicality," it seems clear that the Flamingo has a fixed right to receive the income represented by the casino receivables within the meaning of the "all events" test and should be required to accrue the income represented by them. The

claim is completely unconditional and there is a "reasonable expectancy" that the income will be collectible. As discussed above, it is only the actual receipt of the income that is contingent. The claim is for a sum certain, payable on demand or, in the case of some agreements between the Flamingo and certain makers, within a short period of time, usually thirty days or less. There are no events the occurrence of which could alter the amount that is due the casino or the fact of liability.[16] The markers were in the form of counter checks which would indicate to makers that their execution resulted in a binding obligation. Indeed, the evidence suggests that if the Flamingo were able to magnetically encode the counter checks, the markers would be collectible through normal banking channels unless the maker issued a stop payment order. The fact that the casino is willing to conduct a significant, even essential, portion of its gaming business on the basis of credit indicates that they expect to ultimately receive payment in the form of cash or its equivalent. The existence of this expectancy is also evidenced by the Flamingo's careful credit investigation that precedes the granting of any credit at the casino and the existence of collection procedures short of resort to the courts. The collection experience of the Flamingo, with a collection rate well in excess of ninety percent, indicates that the expectation is "reasonable." Finally, failure to include the markers in income would mean that the Flamingo's income tax return would not clearly reflect in-

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[16] "Liability" as it is used here simply denotes the debtor-creditor relationship between the maker of the marker and the casino. While "liability" often connotes a legally enforceable relationship, particularly when used as a legal term, it has a more general meaning that applies to less binding obligations. The word "right" has similar semantic problems that inevitably have led to some confusion in the interpretation of the "all events" test.

come.[17] To the extent that the markers represent winnings of the casino, failure to include them in income would understate the revenue generated during the taxable period. To the extent that the markers are still advances,[18] the calculation of gross gaming revenues is distorted because, whereas the "drop" is essentially reduced by the amount of the marker, there is no corresponding adjustment of the "fill" to take into account the amount that represents chips still in the hands of the gambler on account of the advance. Short of calling on all gamblers to "settle up" as part of the close of the accounting period, it would be impossible to correct this distortion.

This Court holds, therefore, that the income represented by the casino receivables is accruable under the "all events" test. In so holding, this Court determines that legal enforce-

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[17]The Government seems to argue that, even if normal accrual principles would not require recognition of the income represented by the casino receivables, § 446(b) of the Internal Revenue Code permits the Commissioner to require the accrual in order to "clearly reflect income." This argument appears to go too far. Section 446 provides for selection by the taxpayer of a method of accounting, and § 446(b) only allows the Commissioner to require that the method selected clearly reflect income. There is no real argument that the Flamingo improperly selected the accrual method, and the Government has not suggested that there is an alternative *method* that could require recognition of the income in question here prior to the time the accrual method would. Exact matching of revenues and expenses, while the goal of financial accounting principles, is not a requirement of the tax law. See Eastman Kodak Co. v. United States, 534 F.2d 252, 257-58 (Ct. Cl. 1976); Marquardt Corp., 39 T.C. 443, 453-55 (1962).

Nevertheless, "clear reflection of income" is a factor that may be considered in determining the proper application of accrual principles as part of the necessity to view the reality of a transaction. See Travis v. Commissioner, 406 F.2d 987, 990 (6th Cir. 1969).

[18]Clearly, the Flamingo's income arises only as the result of gambling transactions themselves, not by advancing money for gambling. It is only because of the nature of the casino accounting system that the markers necessarily enter the income calculation.

The markers would only represent advances where the maker was still at the resort, and probably still in the gaming area.

ability is not a necessary element of a fixed right to receive income. Such being the case and there being no genuine issues of material fact, defendant's motion for summary judgment is granted, and plaintiff's motion for partial summary judgment is denied.

Let judgment be entered accordingly.

DATED: February 26th, 1980.

DISTRICT JUDGE

Judgment.

United States District Court for the District of Nevada at Las Vegas.

Flamingo Resort, Inc., vs. United States of America. Civil Action File No. 76-19, RDF.

Filed February 28, 1980.

This action came on for consideration before the Court, Honorable Roger D. Foley, United States District Judge, presiding, and the issues having been duly considered and a decision having been duly rendered,

It is Ordered and Adjudged that defendant's motion for Summary Judgment is granted.

It is Further Ordered and Adjudged that Plaintiff's Motion for partial Summary Judgment is denied.

Dated at Las Vegas, Nevada, this 28th day of February, 1980.

Carol C. Fitzgerald
Clerk of Court
By /s/ Chris Tarin,
Chris Tarin, Deputy Clerk.

Minutes of the Court.

Flamingo Resorts, Inc., Plaintiff, v. United States of America, Defendant. Civil-LV 76-19, RDF.

Dated: May 19, 1980.

Filed May 19, 1980.

Present: the Honorable Roger D. Foley United States District Judge. Deputy Clerk: Preston Bluiett, Jr. Reporter: None Appearing. Counsel for Plaintiff(s): None Appearing. Counsel for Defendant(s): None Appearing. Minute Order in Chambers XXXX.

In Court Proceedings:

The Plaintiff's Ex Parte Motion for Order Indicating Intent to Grant Plaintiff's Motion to Rehear is ordered filed by the Clerk. The same is hereby denied.

IT IS ORDERED that the Plaintiff's Motion to Rehear Plaintiff's Motion for Partial Summary Judgment and Defendant's Motion for Summary Judgment, filed April 7, 1980, is denied.

Carol C. Fitzgerald, Clerk
By: [ILLEGIBLE]
Deputy Clerk

Order.

United States Court of Appeals for the Ninth Circuit.

Flamingo Resort, Inc., Plaintiff-Appellant, v. United States of America, Defendant-Appellee. No. 80-5318.

Filed April 2, 1982.

Before: SNEED, TANG and PREGERSON, Circuit Judges.

The panel as constituted in the above case has voted to deny the petition for rehearing and to reject the suggestion for rehearing en banc.

The full court has been advised of the suggestion for en banc rehearing, and no judge of the court has requested a vote on the suggestion. Fed. R. App. P. 35(b).

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

Order.

United States Tax Court, Washington, D.C. 20217.

Desert Palace, Inc., Petitioner, v. Commissioner of Internal Revenue, Respondent. Docket No. 8531-74.

Upon consideration of the record in this case, the Court has determined that additional briefs are desirable from the parties with respect to the following question:

> If the Court should reject respondent's theory that the accounts receivable in issue may properly be disassociated from the gambling transactions whereby the borrowed money was lost, should the taxpayer nevertheless be required to accrue the amounts represented thereby as income prior to the receipt of payment?

In briefing this question, the parties should consider, in light of the specific facts of this case:

(1) Whether the right which DPI has in the receivables is a legally enforceable right under applicable local law at the time the money represented by such borrowing is lost in gambling (see Stipulation 13); and

(2) Whether legal enforceability of such receivables is a necessary ingredient of a fixed right to receive income from them (see Treas. Reg. 1.446-1(c)(1)(ii)).

Premises considered, it is

ORDERED: That the parties file simultaneous supplemental briefs with the Court in this case with respect to the foregoing on or before January 31, 1979, with simultaneous reply briefs to be thereafter filed on or before February 28, 1979.

(Signed) Lee H. Irwin
Judge

Dated: Washington, D.C.
December 8, 1978

Supplemental Brief for Respondent.

United States Tax Court.

Desert Palace, Inc., Petitioner, v. Commissioner of Internal Revenue, Respondent. Docket No. 8531-74.

Filed March 3, 1979.

PRELIMINARY STATEMENT

This issue, which was severed by order of this Court of October 8, 1976, was presented without trial to Judge Leo H. Irwin on January 11, 1977. The evidence consists of a Stipulation of Facts and exhibits attached thereto (the Judge and Counsel for both parties observed the casino operated by Desert Palace, Inc.).

The Court set the date for the filing of simultaneous Opening Briefs on or before March 28, 1977. On April 1, 1977, the Court granted the respondent's Motion to Accept Brief Out of Time. The respondent's Opening Brief was filed on that same date. The Court set the date for filing of simultaneous Reply Briefs 45 days after the filing of Opening Briefs. By Motion for Extension granted by the Court, Reply Briefs were due May 31, 1977. Reply briefs were timely filed.

On December 8, 1978, the Court ordered that the parties file with the Court simultaneous Supplemental Briefs on or before January 31, 1979, with simultaneous Reply Briefs to be thereafter filed on or before February 28, 1979. On January 24, 1979, the Court granted respondent's Motion to Extend the Time for Filing Supplemental Briefs to March 30, 1979.

A Rule 155 computation will be necessary in any event. It will, however, not be appropriate until the remaining issues are disposed of, either by mutual concession or by trial.

RESPONSE TO QUESTIONS POSED BY COURT

In its Order of December 8, 1978, the Court posed to the parties the following question:

> If the Court should reject respondent's theory that the accounts receivable in issue may properly be disassociated from the gambling transactions whereby the borrowed money was lost, should the taxpayer nevertheless be required to accrue the amounts represented thereby as income prior to the receipt of payment?

If the Court should reject respondent's theory disassociating casino accounts receivable from gambling transactions, the taxpayer should not be required to accrue the amounts represented casino accounts receivable as income prior to the receipt of payment, except to the extent of the casino receivables which were given to the casino at the cage. See respondent's Opening Brief, pp. 48 through 50.

The Court in its Order of December 8, 1978, asked two specific questions. In response to question (1): DPI's right in the casino receivables which resulted from credit granted for gambling purposes is not a legally enforceable right under the law of the State of Nevada at the time the money represented by such borrowing is lost in gambling nor at any other time.

In response to question (2): Legal enforceability of casino receivables is a necessary ingredient in determining when the petitioner's right to receive gambling income is fixed within the meaning of Treas. Reg. § 1.446-1(c)(1)(ii). Under an accrual method of accounting, income accrues only when all the events have occurred which fix the taxpayer's right to receive such income. *United States v. Anderson*, 269 U.S. 422 (1926); *Spring City Co. v. Commissioner*, 292 U.S. 182 (1934). The unenforceability of the gambling debts receivables affects the accrual of income in that it presents a contingency which precludes accrual of

income under the all events test of Treas. Reg. § 1.446-1(c)(1)(ii).

CONCLUSION

It follows that the determination of the Commissioner of Internal Revenue, except as modified herein, should be sustained.

Stuart E. Seigel
Chief Counsel
Internal Revenue Service
By /s/ Lawrence G. Becker
Lawrence G. Becker,
Attorney

Dated: March 16, 1979.

By /s/ Edward B. Simpson
Edward B. Simpson
Assistant District Counsel
Internal Revenue Service
Two Embarcadero Center, Suite 900
San Francisco, California 94111
Tel. No. (415) 556-2572.

Dated: 3-16-79.

Reply Memorandum of Points and Authorities in Support of the Government's Cross-Motion for Summary Judgment.

In the United States District Court for the District of Nevada.

Flamingo Resort, Inc., Plaintiff v. United States of America, Defendant. Civil No. LV 76-19, RDF.

This reply brief will be addressed only to those arguments appearing in the plaintiff's answer to defendant's cross-motion for summary judgment which require further discussion or clarification. In all other particulars, we will rely on the arguments previously submitted in our Memorandum of Points and Authorities in Support of the Defendant's Motion for Summary Judgment.

1. The dispute in this case relates to the tax year in which the plaintiff, a corporation in the gambling casino business, must report income from its business operations. The plaintiff is on the accrual basis of accounting for both business and tax purposes. This permits it to match income with the expenses giving rise to such income in a given accounting period. *United States v. Anderson*, 269 U.S. 422, 440 (1926). Actual cash receipt or expenditure is, accordingly, not the criterion for determining the plaintiff's yearly income or profit and plaintiff has never contended otherwise. Indeed, there is no doubt that the plaintiff expected to derive economic benefits for accelerating the recognition of expenses permissible under accrual accounting. (Mounce Dep. Ex. A, Memo, p. 2.) But in this case, plaintiff seeks to achieve more inflated benefits by departing from its chosen method of accounting and deferring recognition of a substantial part of its gambling income on the ground that actual cash payments on certain "casino receivables" are not made until later years. At the same

time, the plaintiff has taken expense deductions under normal accrual principles and, indeed, even a tax deduction for the face value of chips outstanding at the close of the taxable period (see Gov't. Br. 31-33). There is absolutely no legal basis for rationalizing the current recognition of outstanding chip liability on the expense side and simultaneously deferring casino receivables on the income side. But the plaintiff has attempted to do this and, if sustained in this action, has achieved a massive lessening of its tax liability for the tax year in question, 1967.[1] Such contortions not only generate a tax windfall for the plaintiff, but they are wholly unnecessary in the context of a reasonable scheme of taxing casino income.

In our opening memorandum, we urged this Court to recognize a method of taxing casino income which is both legally sound and comports with the economic realities of the unique circumstances presented by the casino business. The essence of the Government's position is that the play or expenditure of the chip is the determinative event for tax purposes and that a casino realizes income during a taxable period to the extent that it can reasonably value the gains resulting from such expenditures. As we showed in our first memorandum (pp. 17-18), the plaintiff has provided the necessary valuation in this case. The plaintiff does not seriously suggest otherwise. But the plaintiff completely misconstrues the reasoning underlying the Government's position with respect to the casino's income-producing activity.

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[1]The significance of the plaintiff's deferral attempt in this case is readily apparent. The record shows that, for 1967, the plaintiff originally showed book income of $739,000 but sought to reduce such income for tax purposes by deducting the approximately $546,000 net casino receivables outstanding at the close of 1967. (Mounce Dep. Ex. A, Memo, p. 8). The economic benefit to the taxpayer is clear.

There is no doubt that the plaintiff, a gambling casino, derives its income largely from the sale of various hotel services and from the gains registered in its gambling business. To the extent that the plaintiff provides services or conducts games through the medium of chips, the only reasonable manner for computing its yearly income should take into account the gains realized by it on the receipt of such chips.

While legally unenforceable, outstanding chips represent an undeniable business obligation of the plaintiff. In this regard the plaintiff has totally failed to mitigate the impact of *United States v. Hall*, 307 F. 2d 238 (C.A. 10, 1962), on this case. Although the court in *Hall* stated that, due to its legal unenforceability, a gambling debt may not give rise to a "mechanical operation" of the cancellation of indebtedness doctrine, the court clearly ruled that the "elimination of a gambling debt is, however, a transaction that may have tax consequences * * *." Contrary to the plaintiff's rambling protestations, we ask this Court to arrive at nothing more than the conclusions already reached in *Hall*. Accordingly, the receipt of chips by the plaintiff—or a cancellation of the indebtedness represented by the chips—will be deemed to be a taxable transaction and the specific amount of income realized for tax purposes from that transaction will be computed, as here, on an annual basis.

The plaintiff's repeated insistence on the receipt of cash as the event of exclusive significance for tax purposes underscores in several ways the weakness of its overall position. First, the plaintiff thus tacitly admits that the initial exchange of a marker for chips has no immediate tax impact. As we noted in our first brief (p. 11), this results in an asset-for-asset exchange that is a mere preliminary to the taxable event—the recovery of the chip by the plaintiff in its business operation. Second, a cancellation of indebted-

ness triggers realization of income just as the receipt of cash or a cash equivalent. See, e.g., *Riss v. Commissioner*, 368 F. 2d 965, 968-969 (C.A. 10, 1966); 2 Mertens, Law of Federal Income Taxation (Rev. Ed., 1974), §11.19, p. 100. It follows, then, that, for purposes of recognizing income in a taxable period, a cancellation of indebtedness is subject to the same rule as the receipt of a cash equivalent. See generally, *Burnet v. S. & L. Bldg. Corp.*, 288 U.S. 406, 414-415, (1933) (assumption of liability by purchaser treated as actual payment to accrual basis seller in year of assumption)[2]; Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 Tax L. Rev. 225, 226-228 (1959). The plaintiff offers no opposition to this principle and, indeed, it cannot.[3]

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[2]In *Commissioner v. Jacobson*, 366 U.S. 28, 38-40 (1949), the Supreme Court equates the rationale underlying the recognition of income pursuant to the cancellation of indebtedness doctrine with that underlying recognition pursuant to the assumption by a third party of a taxpayer's indebtedness. See also, *United States v. Hendler*, 303 U.S. 564 (1938).

[3]The plaintiff's claim (Reply Br. 3, 9-11) that chips are not full cash equivalents beclouds the issue before this Court. While it is unquestioned that, in the year in suit, a casino chip was accepted as virtual legal tender between the operating casinos in Las Vegas, the focus of the Government's argument is on the substance of the casino business operation. When a chip is initially exchanged for cash, the casino does not derive "income" for tax purposes until it recovers the chip in a game or for other services. No different rule should apply when chips are initially exchanged for markers which have a well-established value. To view the casino's income-producing activities otherwise, as the plaintiff urges, would ignore economic reality. By contrast, the cases principally relied upon by the plaintiff to support its position for income deferral—*Marquardt Corp. v. Commissioner*, 39 T.C. 443 (1962), and *Durr Packing Co., Inc. v. Shaughnessy*, 81 F. Supp. 33 (N.D. N.Y., 1948), aff'd *per curiam*, 189 F. 2d 260 (C.A. 2, 1951), cert. denied, 342 U.S. 850 (1951)—present more conventional situations in which questions concerning accrual of income and expenses arise. The casino business is unique, however, and this Court should not ignore its substance.

2. Because the plaintiff (Reply Br. 3, 10) seriously misstates the position taken by the Government in *Desert Palace, Inc. v. Commissioner* (Tax Court No. 8531-74, awaiting decision) we will briefly clarify this position. The *Desert Palace* case deals with issues identical to those in the instant case. It is true that the Government there argued that, due to the legal unenforceability of pit markers, the taxpayer casino need not accrue income upon the *receipt* of such markers. It is likewise true that the Government there stipulated that outstanding chips do not represent *legal* obligations of the casino. The latter point is a matter of Nevada law, and we do not deviate in the slightest from those positions in this case. Indeed, just as in *Desert Palace*, the Government is here arguing that the taxable event occurs not when the marker is exchanged by a patron for a chip, but when the chip is recovered by the casino in exchange for hotel services or as a gambling "win". The play or recovery of the chip, then, must be viewed as a conclusive taxable event.

Contrary to the plaintiff's contention (Reply Br. 3), the argument presented at pages 20-27 of our first brief is fully in concert with the Government's analysis in this case and in *Desert Palace*. There we urged that the plaintiff's method of accounting in 1967 did not "clearly reflect income" within the meaning of Section 446(b) of the Internal Revenue Code of 1954 by deferring income in the amount of net outstanding casino receivables at the close of the year. As we have previously argued, even an accrual basis taxpayer must report income relating to a cancellation of indebtedness or the receipt of a cash equivalent in the period of cancellation or receipt *unless* the taxpayer can show a proper method for *deferring* such recognition. No such showing is even remotely suggested by the plaintiff here.

It is well established that the policy behind Section 446 of the Code is to bring financial and tax accounting methods into concert whenever possible. It is further undisputed that the accrual method of accounting aims at matching of income and expenses in a given accounting period. The Government's position here and in *Desert Palace* achieves both of these goals, whereas the plaintiff grasps upon an unrealistic analysis of the gaming business to deviate, for tax purposes, from its financial accounting practices and to defer a large part of its 1967 income to a later period, thereby preventing the matching of income and expenses for that year—the principal goal of the accrual method. Under such circumstances, the persuasiveness of the Government's position is clear.

CONCLUSION

For the reasons stated above and in our first brief, this Court should grant the Government's cross-motion for summary judgment and deny the plaintiff's motion for partial summary judgment.

Respectfully submitted,

M. CARR FERGUSON
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Office - Supreme Court, U.S.
FILED
NOV 8 1982
ALEXANDER L. STEVAS
CLERK

No. 82-404

In the Supreme Court of the United States

OCTOBER TERM, 1982

HILTON HOTELS CORPORATION, SUCCESSOR TO FLAMINGO RESORT, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

REX E. LEE
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

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HILTON HOTELS CORPORATION, SUCCESSOR TO FLAMINGO RESORT, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioner seeks review of the decision in this federal income tax case that obligations incurred by gambling customers at a licensed Nevada casino owned by petitioner's predecessor in interest (Flamingo Resort, Inc.) were so fixed, unconditional, and definite as to require that they be accrued by Flamingo for income tax purposes even though the obligations were subject to the affirmative defense under Nevada law that they were gambling debts and therefore not legally enforceable.

The relevant facts may be summarized as follows: Flamingo operated a legal gambling casino in Las Vegas, Nevada, during the year 1967. In connection with its gambling operations, Flamingo extended credit in the form of cash or gambling chips to selected patrons, who executed "markers" in the form of counterchecks in return for the credit (Pet.

App. 3). Approximately 60% of Flamingo's casino play resulted from such extensions of credit (*id.* at 3, 8). According to Flamingo's own estimates, it collected approximately 96% of its casino receivables even though the receivables were not legally enforceable in the state courts (*ibid.*).

Flamingo prepared its income tax returns on the accrual basis but did not include the casino receivables in its income (Pet. App. 2). Instead, it reported the receivables only at the time they were paid. On audit, the Internal Revenue Service concluded that the receivables should be accrued as income. After permitting an appropriate allowance for a reserve for bad debts, the Service determined a deficiency in petitioner's 1967 income taxes of $261,942.65. In this refund suit brought by petitioner in the United States District Court for the District of Nevada, the district court granted summary judgment for the government, holding that the receivables were accruable despite their legal unenforceability (*ibid.*).

The court of appeals affirmed (*id.* at 9). It pointed out that the obligations of Flamingo's patrons were in practical effect as fixed as possible, that the amounts owed Flamingo could be determined with reasonable accuracy, and that the history of Flamingo's business demonstrated that there was a reasonable expectation of collection. In such circumstances, the court concluded, the absence of legal enforceability did not prevent accrual of Flamingo's receivables (*id.* at 7-9).

1. The decision below correctly held that petitioner was required to accrue into income the obligations of its gambling customers, less an appropriate allowance for bad debts.

Under the accrual method of reporting income employed by Flamingo, "income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with

reasonable accuracy." Treasury Regulations on Income Tax (1954 Code), Section 1.451-1(a) (26 C.F.R.). See also Treasury Regulations, Section 1.446-1(c)(ii). This rule, known as the "all events" test, derives from this Court's decision in *United States* v. *Anderson*, 269 U.S. 422 (1926). There, the Court held that a tax on profits from the sale of munitions was accruable (and hence deductible) in the year the munitions were sold and not the following year when the tax became due. The Court rejected the contention that the tax could not be accrued as an expense prior to its assessment, stating (269 U.S. at 441): "In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it."

Anderson therefore makes it clear that legal liability for an expense, or legal enforceability of a right to income, is not always a prerequisite for the accrual of an expense or an item of income. Subsequent to *Anderson*, the decisions of this Court and other courts further demonstrate the correctness of the rule requiring petitioner to accrue the obligations incurred by its customers. For example, in *Continental Tie & Lumber Co.* v. *United States*, 286 U.S. 290 (1932), income was paid to the taxpayer's railroad subsidiary in 1923 as an award by the Interstate Commerce Commission pursuant to Section 204 of the Transportation Act of 1920, ch. 91, 41 Stat. 460, for lost revenues during a period of government control of the railroads. Although the taxpayer contended that the award was accruable in 1923, the year the award was determined and paid, the government contended that the amount was accruable in 1920. Although this Court agreed with the taxpayer that in 1920 "no proceeding was available to compel an allowance [of the award], or to determine the elements which should enter

into the calculation," it nevertheless held that the unenforceable award should be accrued in 1920 (286 U.S. at 295): "The right to the award was fixed by the passage of the Transportation Act. * * * Petitioner's right to payment ripened when the act became law" (*ibid.*). This Court thus rejected the taxpayer's argument that its unenforceable claim did not amount to a fixed right to income for purposes of the "all events" test.[1]

The courts of appeals are in accord with the foregoing analysis. In *Barker* v. *Magruder*, 95 F. 2d 122, 123 (D.C. Cir. 1938), the court rejected the argument that usurious interest, unenforceable under District of Columbia law, was not accruable as income because "the government should not be permitted to tax, under the claim of income, an amount of which, under the law, the taxpayer cannot enforce payment." In holding that such interest was properly accruable, the court stated (*id.* at 122), "[t]he correct answer, as we think, depends not so much, as appellants urge, upon the legal right to enforce collection as upon the existing probability of its being received." The Court of Claims reached the same conclusion with respect to the accruability of usurious interest. *Barker* v. *United States*, 26 F. Supp. 1004 (1939). Likewise, in *Automobile Insurance Co.* v. *Commissioner*, 72 F. 2d 265, 268 (2d Cir. 1934), the court upheld accruability of wartime damages payable by the Mixed Claims Commission, even though such payment was not enforceable by the taxpayer. *Travis* v. *Commissioner*, 406 F. 2d 987 (6th Cir. 1969), is to the same effect. There, the court held that the taxpayer was required to accrue amounts due it on installment contracts for dance lessons even though under state law the right to

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[1] A similar argument was presented to this Court on brief in *Schlude* v. *Commissioner*, 372 U.S. 128 (1963). Although the Court did not discuss it, its decision requiring accrual necessarily rejected it. See also *Travis* v. *Commissioner*, 406 F. 2d 987, 989 (6th Cir. 1969).

receive the installments was not legally enforceable because the contracts were executory. See also *Eastman Kodak Co.* v. *United States*, 534 F. 2d 252, 257 (Ct. Cl. 1976) ("The 'all events' test * * * looks to a liability that is so fixed that the fact of liability is certain and the amount thereof reasonably ascertainable, *although not necessarily legally enforceable*" (emphasis supplied)).

On the other hand, none of the cases cited by petitioner (Pet. 14-15) holds that where, as here, all events fixing a taxpayer's right to income have occurred, the income still is not accruable unless and until the right is legally enforceable. As the district court correctly pointed out (Pet. App. 23-24), the cases upon which petitioner relied below fall into three categories: (1) those in which the taxpayer still had to perform some act in order to bind the other party to the obligation; (2) those in which the claim to income was the subject of actual controversy, as to either liability or amount, during the year at issue, such as *Marquardt Corp.* v. *Commissioner*, 39 T.C. 443 (1962) (Pet. 14); and (3) those in which the contractual income was subject to final determination upon completion. Since this case fits into none of these categories, petitioner's cited authorities are distinguishable.[2]

2. The courts below properly applied the "all events" test to the facts of this case. All the events fixing Flamingo's right to the casino receivables occurred at the time Flamingo provided its patrons with cash or gambling chips on credit and the patrons simultaneously acknowledged their obligations by executing "markers." No further act on the part of Flamingo was required to fix its right to payment of the indebtedness represented by the "markers", the amounts

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[2]Petitioner's reliance (Pet. 11-12) upon *United States* v. *Byrum*, 408 U.S. 125, 136-137 (1972), is also misplaced. The Court's statement there that the term "right" in an estate tax context connotes a legally enforceable power has no bearing on the tax accrual question at issue here.

owed to it could be determined with reasonable accuracy, and there was more than a reasonable expectation of collection. Indeed, according to Flamingo's own estimates, its collection rate on the receivables ranged as high as 96% (Pet. App. 3, 8). In these circumstances, the decision below correctly held that Flamingo's inability to resort to the state courts for enforcement of its fixed right to the casino receivables is not controlling (*id.* at 9).[3] Accordingly, the courts below correctly held that on the facts here Flamingo was required to accrue its receivables notwithstanding their legal unenforceability. Indeed, petitioner's argument that the "all events" test is not satisfied until actual payment occurs is tantamount to seeking cash basis treatment for its income from "markers" even though it is an accrual basis taxpayer.[4]

3. Moreover, as the court of appeals correctly recognized (Pet. App. 9 n.5), it is not of controlling significance that the Commissioner originally conceded in *Desert Palace, Inc.* v. *Commissioner*, 72 T.C. 1033 (1979), appeal pending, No. 82-7091 (9th Cir. filed Feb. 12, 1982), that the lack of legal enforceability precluded the accrual of the casino receivables in that case.[5] As this Court has made clear, the

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[3]As the court of appeals noted (Pet. App. 8), it is doubtful that legal enforceability of the "markers" would or could increase Flamingo's recovery rate. Moreover, the fact that Flamingo conducted the majority of its business (approximately 60%) through extension of credit to its patrons is telling evidence that the lack of legal enforceability of gambling obligations had no practical effect on its operations (Pet. App. 3, 8).

[4]The contrary result urged by petitioner would in effect place casino owners on a hybrid system of accounting under which they would enjoy the dual benefits of reporting a substantial portion of their receipts on the cash basis while continuing to report all their expenses on the accrual basis.

[5]Following the district court's decision in this case, the Commissioner reconsidered his concession in *Desert Palace* and concluded that it had been made in error. Accordingly, he filed a motion requesting the Tax Court to reconsider its decision in *Desert Palace*. The Tax Court, however, denied the motion.

Commissioner is free to change his position if he determines that his prior position was in error. See *Automobile Club* v. *Commissioner*, 353 U.S. 180 (1957); *Dixon* v. *United States*, 381 U.S. 68 (1965).

Finally, there is no basis for petitioner's concern (Pet. 18-21) that the decision below will authorize the deduction of reserves for future expenses (heretofore prohibited) and will thereby result in a tremendous drain on the Treasury. Such reserves are not accruable for tax purposes because they represent contingent liabilities as to which all the events necessary to fix each individual instance of liability have not occurred even though the amount of future liabilities may be highly predictable in the aggregate. Reserves for future expenses thus do not satisfy the "all events" test. Nothing in the decision below leads to a contrary conclusion. See *Brown* v. *Helvering*, 291 U.S. 193 (1934); *Nightingale* v. *United States*, 684 F. 2d 611, 614-615 (9th Cir. 1982). Here, all the events other than actual cash payment have occurred. Since the liabilities in question are not contingent, they were properly accruable in petitioner's income.

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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Solicitor General

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